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# REVENUE RAISING OPTIONS REQUIRED UNDER THE FISCAL YEAR 1988 BUDGET RESOLUTION

## HEARING

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

JULY 17, 1987

**(Part 2 of 2)**

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
76-782 WASHINGTON : 1988

For sale by the Superintendent of Documents, Congressional Sales Office
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S361-26

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# REVENUE RAISING OPTIONS REQUIRED UNDER THE FISCAL YEAR 1988 BUDGET RESOLUTION

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FRIDAY, JULY 17, 1987

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The committee was convened, pursuant to notice, at 10:08 a.m., in Room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman) presiding.

Present: Senators Bentsen, Moynihan, Baucus, Bradley, Riegle, Daschle, and Chafee.

[The press release announcing the hearing follows:]

[Press release No. H-56, July 7, 1987]

### FINANCE COMMITTEE TO HOLD HEARINGS ON BUDGET RESOLUTION

Washington, D.C.—Senator Lloyd Bentsen (D., Texas), Chairman of the Senate Finance Committee, announced today that a series of three hearings will be held to consider the committee's obligation for raising revenues as required under the budget resolution for fiscal year 1988.

"The budget resolution passed by the Congress instructs the Finance Committee to report legislation raising $19.3 billion in new revenues for fiscal year 1988. The hearings will enable the committee to examine all possible options for meeting its goal," Bentsen said.

The hearings will focus on all available revenue options, particularly those included in the Joint Tax Committee's staff pamphlet published on June 25, 1987.

The hearings are scheduled for Wednesday, Thursday and Friday, July 15, 16 and 17, 1987 at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

Senator **BAUCUS**. I guess we can begin. The first panel in our third day of hearings on revenue options will be Dr. Richard Rahn, Vice President and Chief Economist, U.S. Chamber of Commerce; Mr. Rudy Oswald, Director of the Economic Research Department, AFL-CIO; Mr. John Motley, Director, Federal Legislation of the National Federation of Independent Business; and Mr. Paul Huard, Vice President, Taxation and Fiscal Policy of the National Association of Manufacturers.

I will remind the witnesses that you have five minutes for your statements. Your prepared texts will, of course, be included in the record.

Dr. Rahn, why don't you begin?

## STATEMENT OF DR. RICHARD RAHN, PH.D., VICE PRESIDENT, CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE, WASHINGTON, DC

Dr. **RAHN**. Thank you very much, Mr. Chairman. I am Richard Rahn, Vice President and Chief Economist at the United States

Chamber of Commerce, and on behalf of 180,000 members, I wish to thank you for allowing us to testify today.

I will outline $27 tc $47 billion worth of deficit reduction proposals for you to consider, $20 billion being within the jurisdiction of this committee under the present rules.

Discussion of tax increases to date has proceeded in a disturbing manner. We find ourselves debating tax increases on the merits of their progressivity, their acceptability, and even their disguisability.

The fundamental question, "Will Americans be better of given a $20 billion tax increase?", seems rarely to be asked.

Our analysis gives us an unambiguous worse-off answer to that question. Truly bizarre arguments have been made as to why Congress cannot cut spending and why it must increase taxes.

Setting aside specific special interest pleading and ideology, let us look at the facts.

Every time Congress has increased taxes since World War II, spending on average has increased $1.58 for each $1.00 of tax increases. As a result, deficits have tended to grow larger rather than smaller after each tax increase.

Second, increases in tax rates on labor, capital, or directly on goods and services tend to raise less revenue than initially forecast because the tax increases the cost of whatever is being taxed, resulting in a decline in the demand for the item being taxed.

Third, tax increases, by increasing the cost of whatever is being taxed, results in less than optimum allocation of resources which in turn lowers real incomes, reduces job opportunities and raises economic misery.

Taxes alter the return to every activity undertaken by individuals and businesses, thus altering the allocation of resources in the economy away from the most efficient uses as determined by individual decisions in the market.

Fourth, tax increases facilitate increases in Government spending, but beyond a certain percentage of gross national product, increases in Government spending reduce rather than enhance economic growth.

The United States has already passed that point, and further increases in spending will reduce growth. The reduced growth rate occurs for several reasons: the increased cost of tax administration and compliance, the Government sector tends to be less efficient than the private sector, and Government transfer payment programs tend to misallocate resources and provide disincentives for productive economic activity.

Under your rules, the Gramm-Rudman-Hollings Act allows a committee of the Senate or House that receives a budget reconciliation directive to substitute spending reductions equal to up to 20 percent of the revenue increases required by the directive.

In accordance with this provision, we recommend that the committee substitute $3.9 billion in spending reductions for revenue increases; and I hope you would particularly look at COLA adjustments for Social Security and some adjustments in Medicare.

Capital gains taxation. There is a large body of evidence now that a reduction in the capital gains rate would increase tax revenues.

We have had a lot of experience in recent years with increasing and decreasing capital gains rates, and the body of evidence seems to indicate that a maximum capital gains rate of between 15 and 17.5 percent would maximize revenue.

Recently, Professor Lawrence Lindsey of Harvard University did an analysis of everybody's studies, including his own, and after reviewing these, it appears that reduction of the maximum capital gains rate from the current 28 percent to 15 percent would increase revenues between $4 billion and $8 billion in 1988 and between $5 billion and $1 billion in 1989.

This rate reduction would give you more revenue and greatly increase the efficiency of the economy and have many side benefits.

Now, I know when the Treasury representative testified, Senator Wallop had asked him several questions about doing a revenue forecast; and we would recommend that the committee request a dynamic revenue forecast from the Treasury Department, including the effect of the current stock of capital gains, the effect of capital gains tax rates on startup and innovative firms—the source of much capital gains—and an analysis of the second-order effects tht would result from increased capital gain realizations.

A lower capital gains sale a more efficient capital stock allocation and higher employment.

I have listed in my testimony numerous specific items for the Congress to look at both in terms of increased revenue and expenditure reduction. Given the lack of time, I won't review all those for you.

But the proposals we have laid out would help enable the Congress to meet its deficit reduction targets in an economically constructive manner without slowing economic growth, exacerbating poverty, increasing unemployment, or harming the competitiveness of U.S. business.

It is possible for you to make tax and spending adjustments that we believe will ensure a continuation of our near record peacetime expansion.

We urge you to take the constructive course we have recommended rather than burden the economy with a major tax increase, which is guaranteed to increase the misery of our citizens. Thank you very much, Mr. Chairman.

Senator Baucus. Thank you, Dr. Rahn.

The next witness will be Mr. Oswald.

[The prepared statement of Dr. Rahn follows:]

# STATEMENT
on
# REVENUE INCREASES
before the
SENATE COMMITTEE ON FINANCE
for the
U. S. CHAMBER OF COMMERCE
by
Dr. Richard W. Rahn
July 17, 1987

I am Richard Rahn, Vice-President and Chief Economist of the United States Chamber of Commerce. On behalf of our 180,000 member businesses, associations and state and local chambers of commerce, I welcome the opportunity to present our thoughts on the difficult choices that you must make this year.

The recent budget resolution instructs the Senate Committee on Finance and the House Committee on Ways and Means to raise $19.3 billion in new revenues for Fiscal Year 1988 as part of an effort to substantially reduce the deficit. That is the unpleasant task with which your committee is faced. It requires the committee to make difficult choices that will have a lasting impact on the economic future of the country. Proposals that the committee will consider include those that are counterproductive and economically destructive and those that are productive and economically constructive, which will reduce the federal budget deficit, promote prosperity and improve the standard of living of the American public.

The U.S. economy is today much healthier than it was in 1981. Unemployment, inflation and interest rates are all significantly lower. Yet the accomplishments of the last six years are not grounds for complacency, for the economy is weaker than we would all prefer. During the past two years, economic growth has averaged about 2.5 percent and projections for 1987 do not include an improvement over that rate. This lackluster performance can, in large part, be traced to the climate of uncertainty surrounding tax policy.

Discussion of tax increases has, to date, proceeded in a disturbing manner. We find ourselves debating tax increases on the merits of their progressivity, their acceptability and even their disguiseability. Lacking from this debate has been any meaningful discussion over what makes good tax policy. In essence, good tax policy starts with a very simple question, "Does this provision belong in the tax code?" It does not, as has been all too often the case, start with "Can this be taxed?" The fundamental question — "Will Americans be better or worse off given a twenty billion dollar tax increase?" — seems to be rarely asked. Our analysis gives an unambiguous "worse off" answer to that question.

Truly bizarre arguments have been made as to why Congress cannot cut spending and why it must increase taxes. Setting aside specific special interest pleading and ideology, let's look at the facts:

1. Every time Congress has increased taxes since World War II, spending has increased an average of $1.58 for every $1.00 increase in taxes. As a result, deficits have tended to grow larger rather than smaller after each tax increase.

2. Increases in tax rates on labor, capital or directly on goods and services tend to raise less revenue than initially forecast because the tax increases the cost of whatever is being taxed, resulting in a decline in the demand for the item being taxed.

3. Tax increases, by increasing the cost of whatever is being taxed, result in a less than optimum allocation of resources, which, in turn, lowers real incomes, reduces job opportunities and raises economic misery. Taxes alter the return to every activity undertaken by individuals and businesses, thus altering the allocation of resources in an economy away from their most efficient uses as determined by individual decisions in the market.

4. Tax increases, as shown in (1) above, facilitate increases in government spending. But, beyond a certain percentage of Gross National Product (GNP), increases in government spending reduce rather than enhance economic growth. The U.S. has already passed that point and further increases in spending will reduce growth. The reduced growth rate occurs for three reasons: the increased cost of tax administration and compliance, the government sector tends to be less efficient than the private sector and government transfer payment programs tend to misallocate resources and provide disincentives for productive economic activity. As in the case of tax increases, this reduced rate of economic growth results in fewer job opportunities, less progress against poverty and more economic misery.

Reconciliation Substitution

Section 310(c) of the Balanced Budget and Emergency Deficit Control Act of 1985 (P.L. 97-177, Gramm-Rudman-Hollings) allows a committee of the Senate or House that receives a budget reconciliation directive to substitute spending reductions equal of up to 20 percent of the revenue increases required by the directive. In accordance with this provision, we recommend that the committee substitute $3.9 billion in spending reductions for revenue increases. In particular, we recommend that the committee consider the price-indexed bond proposal described below or reduce entitlement spending within its jurisdiction.

In addition, we recommend the following revenue raising options for your consideration.

Capital Gains Taxation

The Tax Reform Act of 1986 marked a significant change in American tax policy. The Act recognized that high marginal tax rates served to hinder economic growth by reducing incentives to work, save and invest. Tax rates were lowered almost across the board, for both individuals and businesses. I say almost across the board because the Act failed to extend that principle to the treatment of capital gains. Rather than lower the capital gains rate, as was done for all other forms of income, that rate was raised from 20 to 28 percent, a 40 percent increase. If you consider state income taxes, the capital gains rate was in some cases increased by as much as 66 percent.

Capital gains have shown a strong sensitivity to tax rates. In the years 1969-1975, when capital gains were taxed at a rate of 42.5 percent, there was essentially no growth in capital gains realization. When the rate on capital gains was increased further in 1976 — to 49 percent — there was again little growth in capital gains notwithstanding the high rate of inflation. When rates on capital gains were finally reduced in 1979 the effect was not, as many had predicted, a revenue loss. Quite the contrary. Capital gains increased from $45.3 billion in 1977 to $73.4 billion in 1979. This increase in the amount of capital gains realized in 1979 translated into $2.6 billion of additional revenue despite the lower tax rate applied to those gains. In 1981 the rate on capital gains was reduced from 28 to 20 percent, and resulting in further federal revenue gains of more than $1 billion per year.

Dr. Lawrence Lindsey, of Harvard University and the National Bureau of Economic Research, has examined the relationship between tax rates and capital gains. His findings confirm the negative effect of high capital gains taxes on federal revenues and indicate that large revenue gains are possible from a reduction in the capital gains tax rate. Dr. Lindsey's re-estimation of Martin Feldstein's work, excerpted in Table I, led him to project a $7.7 billion increase in federal revenues for 1988 following a reduction in the capital gains rate to 15 percent. Over the period 1988-1991 this gain could amount to as much as $43.2 billion. Lindsey's own model predicts that reducing the rate to 15 percent would increase revenues by $19.2 billion.

### TABLE I
### POTENTIAL REVENUE EFFECT OF A FIFTEEN PERCENT CAPITAL GAINS TAX
($ billions, fiscal years)

| Revenue | 1988 | 1989 | 1990 | 1991 | Total |
|---|---|---|---|---|---|
| Feldstein | 7.73 | 10.99 | 11.80 | 12.73 | 43.2 |
| Lindsey | 3.49 | 4.92 | 5.25 | 5.57 | 19.2 |

Source: Lawrence Lindsey, Capital Gains Taxes under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions (Cambridge, Massachusetts: National Bureau of Economic Research, 1987)

Increases in capital gains realization would come primarily from the affluent. In other words, reducing the capital gains rate would increase the progressivity of the tax system by increasing the share of the overall tax burden borne by upper income taxpayers. The experience of 1981-1985 shows how dramatic this effect can be. As Table II shows, time periods with lower capital gains rates have been associated with increases in capital gains by each and every income group. All income classes increased their realization of capital gains, although upper income groups increased their capital gains, and therefore their taxes, by a larger amount than lower income groups.

An increase in capital gains realization allows individuals to adjust their portfolio holdings. At a lower rate, individuals are no longer "locked in" to existing investments because they would not lose as high a percentage of their equity to the government. The ability to engage in portfolio adjustment is an integral part of a free market economy and will enhance efficiency and promote economic growth. Moreover, these individuals will be more willing to invest in entrepreneurial ventures once the tax on success is smaller.

Clearly, a reduction in the capital gains tax rate will have the benefit of providing at least $3.5 billion in additional revenue for the government. Moreover, it will increase capital formation and venture capital, which in turn will create more jobs and income for our citizens.

TABLE II
NET LONG-TERM CAPITAL GAINS 1978-1984

| AGI Class ($000) | %Change 1978-1981 | % Change 1981-1984 |
|---|---|---|
| 0-25 | 36.1% | 78.8% |
| 25-50 | 13.3 | 53.9 |
| 50-100 | 69.7 | 88.4 |
| 100-500 | 120.9 | 76.8 |
| 500 and above | 302.7 | 169.1 |

Source: Statistics of Income, Internal Revenue Service, 1978-1984.

## Tax Court Docket Relief

As of March, 1987, the Tax Court had an enormous backlog of 79,300 cases. A single case can take as many as 10 years before it is heard. The effect of this backlog is twofold. It is unjust to the taxpayer and it deprives the federal government of revenues for years. It is also unfair that taxpayers must wait years to have their disputes with the Internal Revenue Service (IRS) resolved, because the potential penalties and interest compound and uncertainty continues. Speedy resolution of disputes is a central notion of American justice. Moreover, the federal government is deferring billions in revenues by allowing the backlog to become so serious.

Several members of Congress have suggested that the government allow taxpayers to settle their disputes with the IRS for a fixed percentage of the amount in dispute, plus interest. Such an approach would have the quadruple benefit of aiding the administration of the civil justice system, enhancing federal tax revenues during a period when revenues are badly needed, reducing Tax Court administrative expenses and freeing I.R.S. personnel for other enforcement purposes. This revenue raising option could, based on the number of outstanding cases and average awards, conceivably raise billions of dollars and should raise at least one billion dollars. This option deserves serious study to determine if there are any reasons not to go forward with it and to establish sound procedures for implementation of the proposal. Similar possibilities should be explored for tax cases before the U.S. District Court and the Court of Claims.

## Naval Petroleum Reserves

Running an oil field is a business and should not be a government activity. However, for the past decade the Naval Petroleum Reserve (NPR) has operated as a government-owned oil field. It has sold oil at rates far below the market price. It is also burdened with many unnecessary government regulations.

The Office of Management and Budget (OMB) estimates that about $2.5 billion in annual receipts can be generated from the sale of NPR to the private sector. Critics allege that such oil should remain in the ground for security reasons. However, halting production is no longer a realistic option. Once production has begun, the wells cannot be easily plugged because oil would seep into areas from which it cannot be recovered. The government also owns the Strategic Petroleum Reserve, a preferable way to handle a crisis because it can pump oil 30 times faster than the NPRs.

## Financial Asset Sales

A large amount of revenue can be generated by sales of federal loans. A 1984 Congressional Budget Office (CBO) study estimated a potential one-time net cash inflow to the Treasury of $95 billion if $208 billion of the federal loan portfolio were sold. The President's budget contains a much smaller, politically achievable, package of sales with a face value of $11.2 billion which would generate about $5 billion in revenues for 1988. A Heritage Foundation study concludes that asset sales could realistically yield $10 billion for 1988.

Critics argue that loan asset sales do not constitute real deficit reduction. However, loan asset sales do increase the cash flow of government on a dollar for dollar basis. This enables Congress to meet its deficit reduction targets while putting into place spending reduction packages that generate larger savings in the out-years. Selling such loans also makes the federal subsidy imbedded in these loans come to light, potentially curbing program abuse. Precedent for this approach was established when Congress counted the Rural Electrification Administration (REA) pre-payment as savings in the 1988 budget resolution. This-payment has the same upfront cash flow element as loan asset sales.

## User Fees on Inland Waterway Projects

The Corps of Engineers (COE) currently spends $3 billion annually on multipurpose water projects. Under current law, COE user charges are low and in some cases nonexistent. Waterway users (i.e., commercial shippers) currently contribute only 8 percent of federal expenditures on the inland waterway system. The burden of waterway projects continues to fall on the taxpayers' shoulders. According to the Congressional Budget Office and the Heritage Foundation, if annual user fees that covered operating and capital costs were levied, they would reduce the deficit by $1 billion annually.

Below-cost user fees have had other harmful effects besides contributing to the size of the federal deficit. These include creating excess demand for new dredging and construction projects and promoting artificially high use of shipping for transporting goods rather than less costly modes of transportation.

Contrary to critics' claims, increased user fees would not be financially ruinous for U.S. shippers. The CBO has estimated that full-cost recovery user fees for ports and harbors would increase the cost of goods only slightly.

## User Fees For Federal Credit Programs

Increased user fees on a wide variety of federal credit programs (Veterans Administration loans, Federal Housing Administration loans, Commodity Credit Corporation, export credit loans, maritime loans, education loans, and REA loans) have been proposed. The proposal is related to Grace Commission recommendations to improve federal credit policy. The basic proposal is to implement a 5 percent origination fee for most of these loans. The proposal would affect more than 85 percent of newly guaranteed loans that do not currently have such a fee in place. OMB estimates revenues of $1.5 billion for the first year.

Individuals and businesses who use such loans would have to confront the higher user fees. However, other borrowers must pay higher interest rates, receive less favorable credit terms or are unable to get credit at all because the federal government has channeled credit to the borrowers whom it favors.

## Coast Guard User Fees

User fees could be established for U.S. Coast Guard services that provide direct benefits to commercial mariners and other users. According to CBO, such user fees could generate $900 million in deficit reduction annually.

Just as automobile owners assume the costs of building and maintaining roads and as local taxes pay the costs of police and fire protection, so should boat owners help defray the costs of federal services provided solely for their benefit. In addition, the burden on most recreational boat owners would be small; the CBO estimates that fees for recreational boaters would be less than $20 per year. The impact of fees on the fishing industry and commercial shippers would be greater but not overly burdensome. User fees would merely cause industry prices to reflect more accurately the real cost of these commercial activities.

## Auction of the Unassigned Spectrum

The Administration proposes the use of auctions, instead of the present practice of using hearings and lotteries, to assign Federal Communications

Commission licenses for use of the unassigned spectrum. Revenues generated from such sales are estimated to be $600 million annually.

Auction authority will not affect the terms of licenses awarded and will not apply to licenses awarded in any medium of mass communications or for public safety or amateur services. Public auctions will capture the true value of the license and give taxpayers a return for the use of the spectrum, which is public property.

## Excess Real Property

The President's Private Sector Survey on Cost Control and the General Accounting Office (GAO) point to the need for better policies for federal asset disposal. Because agencies are often not compensated for asset dispositions, little incentive exists for such sales. Congress must also approve even very small sales.

Critics point out that such sales may disrupt the real estate market. However, such sales could be phased-in over a period of years. Furthermore, the amount that is currently marketable represents only one-half of one percent of all federal landholdings. Selling such property could yield as much as $1.0 billion in annual receipts, according to the Private Sector Survey on Cost Control.

Private ownership would transform nonessential federal real property into taxable, wealth-creating assets. If federal property of minimal national significance were transferred to the the private sector, all parties would benefit: developers could use the property for profit-making ventures, local communities would have a larger tax base at their disposal and the federal government would gain revenues to offset the deficit.

## Price-Indexed and Gold-Backed Bonds

Price-indexed bonds and gold-backed bonds could save the Treasury interest expense. These inflation-proof bonds would compensate investors for unexpected changes in the inflation rate. Thus, the Treasury would no longer have to compensate investors for inflation uncertainty when issuing new bonds. One third of all new bonds in Great Britain have been so indexed since 1981. Further studies should be done to estimate the impact of inflation-proof bonds in reducing our federal deficit.

For example, estimates from the Heritage Foundation suggest that such inflation-proof bonds could, with as little as a two percentage point reduction in the cost of federal borrowing, generate up to $12 billion in annual interest saving and deficit reduction. Other estimates predict a more modest savings of three billion dollars in the first few years, increasing to $12 billion after full implementation of the program.

## Amtrak

According to OMB, privatization of Amtrak could yield $1.6 billion in 1988. Privatization of some or all of the system could be made a sound political alternative by giving key constituencies (Amtrak employees, management, passengers) an ownership stake in the railroad and eliminating subsidies through improved efficiency. By turning Amtrak assets over to the private sector in return for terminating the subsidy, a net savings to the taxpayer results. Moreover, if Amtrak were private, it would pay local, state and federal taxes.

Proponents of such a strategy argue that the current subsidy provides little incentive to cover costs. Cutting subsidies would therefore effectively reduce federal outlays and promote efficiency. Amtrak carries less than 0.3 percent of all intercity passenger traffic in this nation. Even on the heavily traveled portions of the Amtrak route structure, more than half of its heavily subsidized patrons have incomes above $30,000, resulting in an Amtrak subsidy that serves to redistribute income upwards.

As is the case with most federal subsidies, the subsidies afforded Amtrak could have created several times as many new jobs in the private sector. If Amtrak were sold to the private sector, profitable and popular routes would not be eliminated but rather would be operated by more cost-efficient, taxpaying, private owners.

## Military Bases

According to the President's Private Sector Survey on Cost Control, many Department of Defense installations can be consolidated and many others can be eventually phased-out. A portion of the real property associated with these sites could be sold to the private sector or state and local governments. Although smaller communities could suffer adjustment problems, these problems could be overcome with an orderly phase-out of these installations.

Selling or renting commissaries for private sector usage and management is also another source of revenue. Investigations have shown that such commissaries are operated inefficiently and are heavily subsidized. Studies by the Grace Commission have shown that military and private sector pay scales are equivalent. Therefore, the commissary subsidy is not needed. Even if such subsidies were useful, a voucher system would be far more efficient than federally operated stores.

Deficit reduction derived from base closures and consolidations and rental income from privately owned commissaries could yield at least $1.5 billion annually, according to the Grace Commission.

## Conclusion

Table III summarizes the revenue raising options discussed above.

REVENUE RAISING OPTIONS

| Option Description | Fiscal Year 1988 Revenues (Billions of dollars) |
|---|---|
| Reconciliation Substitution | $3.9 |
| Capital Gains | $3.5-7.7 |
| Tax Court Docket Relief | $1.0-3.0 |
| Military Base Reform | $1.5 |
| Naval Petroleum Reserve Sales | $2.5 |
| Excess Real Property Sales | $1.0 |
| Credit User Fees | $1.5 |
| Financial Asset Sales | $5.0-10.0 |
| Price-indexed Bonds | $3.0-12.0 |
| Amtrak | $1.6 |
| Inland Waterways User Fees | $1.0 |
| Coast Guard User Fees | $0.9 |
| Unassigned Spectrum Auction | $0.4 |
| TOTAL REVENUE RAISING OPTIONS | $26.8-47.0 |

Each of these proposals would help to enable the Congress to meet its deficit reduction targets in an economically constructive manner, without slowing economic growth, exacerbating poverty, increasing unemployment or harming the competitiveness of U.S. business. The pattern of federal spending, however, forces one into a pessimistic appraisal when assessing the uses to which these revenues might be put. With federal revenues at record levels for a peacetime economy, and for many wartime periods for that matter, it is hard to believe that additional federal revenues will result in anything but additional federal spending. To the degree that these proposals result in more spending, then whatever beneficial features that they possess in the abstract will at least in part be negated.

It is possible for you to make tax and spending adjustments that we believe will ensure a continuation of our near-record peacetime expansion. We urge you to take the constructive course we have recommended rather than burden the economy with a major tax increase, which is guaranteed to increase the misery of many of our citizens.

Thank you for the opportunity to present our views on the important issue of how best to raise the revenues necessary to meet the budget resolution requirements.

## STATEMENT OF RUDY OSWALD, DIRECTOR, ECONOMIC RESEARCH DEPARTMENT, AFL-CIO, WASHINGTON, DC

Mr. Oswald. Thank you, Mr. Chairman. I am happy to appear as the Chief Economist of the AFL-CIO, representing some 13 million members, and to be able to state what we feel are fair and equitable measures to meet the budget resolution revenue targets.

The effect of the 1981 tax cut, the rapid buildup of defense spending, and mounting interest costs have resulted in a budget deficit estimated at nearly $140 billion and a debt expected to exceed $2.6 trillion.

Revenue raising action is essential, and we support your efforts. But central to our support for additional revenue is our strong belief that any new revenues be raised on the basis of ability to pay.

For that reason, we urge the committee to focus its attention on the individual and corporate income tax and the estate and gift tax in fulfilling the revenue targets with the Concurrent Resolution on the Budget for Fiscal Year 1988.

We are opposed to new or expanded sales, excise, or other consumption taxes. Regressive taxes are contrary to the goal of tax justice and the intent of Congress just last year in enacting the 1986 reforms.

We also remain vigorously opposed to any renewed attempts to tax employer-provided workplace benefits. Specifically, we suggest that the necessary funds be generated through actions in the following areas: (a) maintain the top individual tax rate at 38.5 percent, rather than 28 percent; (b) make the current individual tax rate of 33 percent explicit, rather than a phase-in, phase-out rate; (c) reduce corporate tax rate to 38.5 percent, rather than the current 34 percent; (d) change the foreign tax credit to a deduction and eliminate the deferral privilege for U.S. corporate income earned abroad; (e) impose a surtax on upper income individuals and corporations; (f) close the capital gains at death loophole and eliminate reductions in the estate and gift tax rates; and (g) close such loopholes as limited partnerships and preferential accounting rules.

Revenue from these sources could far exceed the $19.3 billion called for in fiscal year 1988 and a three-year total of $64.3 billion.

The foregoing proposals are options the Congress should consider in its search for needed revenue. These alternatives would raise revenue in a fair and equitable fashion forwarding the goal of tax reform.

The changes we recommend would also offset the loss of revenue after 1988 anticipated as a result of the 1986 Tax Reform Act.

That 1986 bill removed most of the working poor from the tax rolls and required corporations to shoulder a fairer share of the tax burden.

The legislation, however, went too far in cutting tax rates for wealthy individuals and highly profitable corporations.

As a result, although the 1986 effort did much to achieve goals of taxing equals equally, it did little to make the tax structure more progressive.

We urge that the promise of tax reform be kept and rate schedules be enacted that reflect the principle of taxation based on the ability to pay.

Beyond the matter of tax receipts is the broader issue of social responsibility demonstrated by the share of taxes required of individuals and corporations.

Taxpayer morale and support by Americans of the fiscal underpinnings of the Federal Government can be ensured only by continued Congressional action to spread the tax burden equitably.

The AFL-CIO urges Congress to freeze the top individual tax rate at 38.5 percent, rather than reduce it to 28 percent. The 38.5 percent rate would apply to income above $225,000 and would raise some $4.7 billion in 1988.

The top rate has already been reduced substantially. Following World War II, the top rate was 91 percent. In 1965, it was 70 percent; and in 1981, the top rate was cut to 50 percent.

Now, in 1987, the rate is 38.5 percent with a further reduction to 28 percent scheduled for 1988.

In our estimation, this is too large a cut in the taxes of the wealthy.

We wish that we could come before you and claim that the Federal deficit can be ignored, or that simple, painless measures—particularly on the spending side of the equation—will do the trick. The facts, however, are otherwise.

The unfair and revenue devastating 1981 tax cut costs some $259 billion in 1988 revenues lost. Ten actions since that time to increase Federal receipts offset that loss so that now it is only $136 billion, an amount sufficient to wipe out nearly all the deficit expected in 1988.

Inflation adjusted defense outlays since 1981 have grown by 44 percent, and interest rates on the debt—also in real terms—have more than doubled in that same period.

Moreover, if we are to believe the President's claim that his proposals for defense and domestic spending in 1988 reflect the lowest levels of such spending in keeping with the nation's needs, then the only way to achieve the balanced budget that the President continues to advocate is to increase revenues.

Revenue can be raised, and it can be done in a fair and evenhanded way. It can leave intact the 1986 tax structure for most Americans, by asking the wealthiest to take a somewhat smaller cut in their taxes. Thank you, Mr. Chairman.

Senator BAUCUS. Thank you, Mr. Oswald.

Our next witness will be Mr. Motley.

[The prepared statement of Mr. Oswald follows:]

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## STATEMENT OF RUDOLPH A. OSWALD, DIRECTOR
## DEPARTMENT OF ECONOMIC RESEARCH
## AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
## BEFORE THE SENATE COMMITTEE ON FINANCE
## ON REVENUE OPTIONS

July 17, 1987

The AFL-CIO is pleased to have this opportunity to recommend fair and equitable measures to meet the budget resolution revenue targets.

The effects of the 1981 tax cuts, the rapid buildup in defense spending and mounting interest costs have resulted in a budget deficit estimated at nearly $140 billion and a debt expected to exceed $2.6 trillion. Revenue raising action is essential and we support your efforts. But central to our support for additional revenue is our strong belief that any new revenues be raised on the basis of ability to pay. For that reason, we urge the Committee to focus its attention on the individual and corporate income tax and the estate and gift tax in keeping with the Concurrent Resolution on the Budget for Fiscal Year 1988.

We oppose new or expanded sales, excise, or other consumption taxes. Regressive taxes are contrary to the goal of tax justice and the intent of Congress last year in enacting the 1986 reforms. We also remain vigorously opposed to any renewed attempts to tax employer-provided workplace benefits.

Specifically, we suggest that the necessary funds be generated through actions in the following areas:

A. Maintain the top individual tax rate at 38.5 percent, rather than the 28 percent under current law;

B. Make the current individual tax rate of 33 percent explicit, rather than a phase-in, phase-out rate;

C. Reduce the corporate tax rate to 38.5 percent, rather than the current 34 percent;

D. Change the foreign tax credit to a deduction and eliminate the deferral privilege for U.S. corporate income earned abroad;

E. Impose a surtax on upper income individuals and corporations;

F. Close the capital gains at death loophole and eliminate reductions in the estate and gift tax rates; and

G. Close such loopholes as limited partnerships and preferential accounting rules.

Revenue from these sources could far exceed the $19.3 billion called for by Congress in fiscal year 1988 and the three-year 1988-1990 total of $64.3 billion. The foregoing proposals are options that Congress should consider in its search for needed revenue. These alternatives would raise revenue in a fair and equitable fashion forwarding the goal of tax reform. The changes we recommend would also offset the loss of revenue after 1988 anticipated as a result of the 1986 Tax Reform Act.

The 1986 tax bill removed most of the working poor from the tax rolls and required corporations to shoulder a fairer share of the tax burden. The legislation however, went too far in cutting tax rates for wealthy individuals and highly profitable corporations. As a result, although the 1986 effort did much to achieve goals of taxing equals, equally it did little to make the tax structure more progressive.

We urge that the promise of tax reform be kept, and rate schedules be enacted that reflect the principle of taxation based on the ability to pay. Beyond the matter of tax receipts is the broader issue of social responsibility demonstrated by the share of taxes required of individuals and corporations. Taxpayer morale and support by Americans of the fiscal underpinnings of the federal government can be ensured only by continued Congressional action to spread the tax burden equitably.

The AFL-CIO urges Congress to freeze the top individual tax rate at 38.5 percent, rather than reduce it to 28 percent. The 38.5 percent rate would apply to taxable income above $225,000 and would raise $4.7 billion in 1988 revenue and $26.9 billion over three years. The top rate has already been substantially reduced. Following World War II, the top rate was 91 percent. In 1965, it was reduced to 70 percent, and in the 1981 legislation, the top rate was cut to 50 percent. For 1987, the new rate of 38.5 percent is effective, with a further reduction to 28 percent scheduled for 1988. In our estimation this is too large a cut in the taxes of the wealthy.

The current phase-out rate of 33 percent applying to taxable incomes of more than $71,900 should be made an explicit rate of 33 percent and not be hidden by the current phase-in, phase-out provisions. It would apply to taxable incomes between $71,900 and $225,000. This proposal would raise $2.8 billion in 1988, and $18.2 billion over the three-year period.

Both of these proposals would only affect those with incomes of approximately $90,000 or more and would leave intact the 1986 Tax Reform Act rates and exemptions for low and moderate income families.

We also recommend a top corporate rate of 38.5 percent, rather than the cut to 34 percent called for in the Tax Reform Act. This proposed 38.5 percent rate is substantially lower than the 46 percent rate applied to taxable income of $100,000 or more that was in effect until June 30 and would yield approximately $4 billion in 1988 and $14 billion over three years. This rate would also eliminate the anomaly under the current code, where corporations with taxable income of $100,000 to

$335,000 would pay a marginal rate of 39 percent under current law, while corporations with profits over $335,000 face a marginal rate of 34 percent. Despite the revenue raising corporate tax reforms enacted last year the share of taxes paid by corporations is still far below the levels of the mid-1950s when corporate business financed over a quarter of the federal budget. In 1988, less than 13 percent of federal tax revenues are expected from corporations.

We also urge that the foreign tax credit be changed to a deduction and the deferrability of taxes on profits earned abroad should be ended. American firms investing and producing abroad should not be subsidized by special U.S. tax privileges. Like state and local taxes, foreign income taxes should be considered a cost of doing business and deducted from the taxable income rather than the present system of credits against tax liability. Also the U.S. tax should be paid when the profits are earned, not at some future time (or never) as currently provided under foreign source income rules. In addition to ending a subsidy which encourages U.S. corporations to invest and produce overseas, these changes would yield approximately $10 billion in 1988 and $35 billion over three years.

We would also support a corporate surtax on tax over $10,000 and a surtax on individuals with a tax liability higher than $10,000. A 5 percent surtax applied to wealthier corporations and individuals who are best able to afford the additional burden (primarily families with incomes of over $70,000) would amount to $3.3 billion from corporations in the first year, and $15.7 billion over three years. A 5 percent surtax on individuals would amount to $3.1 billion in 1988 and $16.7 billion over three years.

The estate and gift tax represents a source of revenue and tax equity. Currently this fairest and most progressive tax accounts for only 6 percent of federal revenues. We recommend that the rates be frozen at the 1987 level rather than suffer the revenue loss that would result from dropping the rate to 50 percent on transfers of over $2.5 million. In addition, we believe that Congress should use this opportunity to end the revenue losses resulting from the present law non-taxation of capital gains passed on to heirs. A three year revenue gain of $12.6 billion would result.

The AFL-CIO also supports the proposals to tax as corporations the "Master" Limited partnerships that are publicly traded and to put an end to the many opportunities for tax avoidance through accounting techniques such as inventory pricing and cash rather than accrual based deductions. Such measures would raise as much as $6 billion in 1988 revenue and $27 billion over the 1988-1990 period.

We repeat our strong opposition to the use of regressive excise taxes and general sales or value added taxes to raise revenue. Since such taxes place most of the burden on low- and moderate- income consumers turning to excise taxes would reverse the steps toward fairness taken in 1986 and represent a breach of faith with the American people. Instead of using the taxes that are based on ability to pay, a shift to excises would be a move towards a more regressive tax structure. We believe that's bad tax policy.

Just one note in closing on the alternatives listed in the options of June 26, pertaining to taxing employee benefits. We believe this issue goes far beyond tax and budget considerations into basic social policy. Attempts to reap fiscal rewards by taxing employee benefits is grossly unfair to the tens of millions of American workers who depend on benefits that have become the basis of a life-support system.

Up to 140 million Americans for example, now rely on job-related health care insurance protection -- so this is hardly a nonessential benefit available to a select few. But, most important to tax health and life insurance, pensions, education, legal services, child care and other employer-paid benefits as if they were income would destroy an established social policy without providing an alternative.

The AFL-CIO options amount to nearly $34 billion in 1988 revenue and to $166 billion over three years. We are not urging an increase of this magnitude, but rather offer alternatives that we believe are the preferred options that the Congress should consider.

We wish that we could come before you and claim that the federal deficit can be ignored or that simple, painless measures particularly on the spending side of the equation will do the trick. The facts however, are otherwise. The unfair and revenue devastating 1981 tax cut, costs $259 billion in 1988 revenues lost. Ten actions since that time to increase federal receipts offsets the loss reducing it to $136 billion -- an amount sufficient to wipe out nearly all the deficit expected in 1988. Inflation adjusted Defense outlays, since 1981, have grown by 44 percent and interest payments on the debt, also in real terms, have more than doubled in the 1981-1988 period. Moreover, if we are to believe the President's claim that his proposals for defense and domestic spending in 1988 reflect the lowest levels of such spending in keeping with the nation's needs, then the only way to achieve the balanced budget that the President continues to advocate is to increase revenues.

Revenue can be raised and it can be done in a fair and even-handed way. It can leave intact the 1986 tax structure for most Americans, by asking the wealthiest to take a somewhat smaller cut in their taxes.

## AFL-CIO Options To Meet Budget Targets
(Billions of dollars)

| Proposals | 1988 Revenue | Revenue over Three Years |
|---|---|---|
| Maintain top rate of 38.5% | $4.7 | $26.9 |
| Make 33% rate explicit | 2.8 | 18.2 |
| Lower top corporate rate to 38.5% instead of 34% | 4.0 | 14.0 |
| Enact a 5% surtax on individual income taxes of over $10,000 | 3.1 | 16.7 |
| Enact a 5% surtax on corporate tax over $10,000 | 3.3 | 15.7 |
| End foreign tax credit and deferral | 10.0 | 35.0 |
| Retain 1987 estate and gift tax rates and tax capital gains at death | -- | 12.6 |
| Taxation of limited partnerships and accounting reforms | 6.0 | 27.0 |

## STATEMENT OF JOHN MOTLEY, DIRECTOR, FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

Mr. MOTLEY. Thank you, Mr. Chairman. On behalf of NFIB's 515,000 members coast to coast and the 225,000 members that reside in the States of the members of this committee, I would like to thank you for the opportunity to testify here today.

While the focus of this hearing is on raising revenue to meet the reconcilation targets given the committee, I think I would be terribly remiss if I did not start out by saying that NFIB members still maintain their objection to tax increases to reduce the deficit.

They firmly believe that the deficit is a spending problem and not a revenue problem. A decade of polling and surveys of our membership show that they clearly believe that spending in this country is out of control and that Congress should move to bring that spending under control before any major tax increases are begun.

The 1986 White House Conference on Small Business last August concurred with this. Their number four recommendation was more than 1,200 votes; it was simply a menu of those things that Congress should do to help bring down spending.

Again, we have another reaffirmation of it. NFIB currently has one of its mandate polls in the field, and the question that we ask gives the members three options for reducing the deficit. Two of those options combine tax increases with spending cuts. One of them is a stock transactions tax and cut spending. The second one is a gasoline tax and cut spending. The third one is to cut spending solely.

I don't think I need to tell you how the vote would come out; but on the stock transaction tax and cutting spending, 19 percent favored that; gasoline tax and cut spending, 8 percent favored it; cut spending alone, 71 percent were in favor of that.

So, I think it is pretty clear that our membership across the country still believes that Congress can do more in the area of cutting spending.

Therefore, NFIB will not support any tax increase, even if it is thoroughly dedicated to reducing the deficit.

While we oppose tax increases, there are certain revenue raising options put forward by the Joint Committee that, from our standpoint, are worse than others. Therefore, I would like to spend a few minutes to discuss personal and corporate rates, estate taxes, FUTA taxes, and capital gains taxes.

First of all, personal and corporate rates, Mr. Chairman. The number one priority in tax reform last year of the small business community was reductions in both personal and corporate rates.

Small businesses, especially those in capital-intensive areas, traded their deductions for rate cuts. To raise rates at this time, we believe, would be a breach of faith with those businesses.

Small corporations, those under $25,000 a year in taxable income, received no rate cut last year. Therefore, any additional increase in their rates this year would be second tax increase or a tax increase two years in succession.

Turning to estate taxes, Mr. Chairman, the discussion of the State tax in here and in the Ways and Means Committee is one of deja vous. It seems we had this debate in 1976 and in 1978 and in 1981; and we decided at that time that estate taxes were a fairly efficient way of raising revenue, raising less than one percent of total Federal revenues at a very high cost.

Estate taxes also provide a great hardship for many small business owners and farmers across this country. They are forced to seek expert advice simply to protect their farms or their businesses from being sold out to meet tax obligations.

They also have to expend precious resources and capital in terms of buying insurance to protect their farms and businesses against the day that they may have to pay a large estate tax bill, therefore cutting down on the amount of money they can put into those businesses and farms and the number of jobs that they can create.

And of course, I have already mentioned the worst scenario, that is, when an individual has spent his life and a lot of the family's hard sweat and equity over the years, building a business. That business is forced to be put on the block to be sold off to meet tax obligations.

Elimination of estate taxes for closely held businesses were very high recommendations of the 1980 and 1986 White Conferences on Small Business.

Payroll taxes are the most onerous for labor-intensive small businesses in this country; and while individual and corporate rates have been cut, payroll taxes now account for roughly one-third of all Federal revenues.

We oppose both the extension of the temporary FUTA surcharge and the indexing of the FUTA wage base.

I will spend just a minute on capital gains taxes, Mr. Chairman. It is the only revenue raising option from the Joint Committee's paper that we can wholeheartedly support.

Small business owners have believed for a long time that cutting capital gains taxes is an incentive for people to invest in their businesses; and raising necessary capital for business operations is a constant problem for most small business owners.

NFIB believes that capital gains tax cuts would spur investment in smaller businesses, increase economic activity, and raise revenues.

And we believe that that is preferable to raising taxes, dampening economic activity, and in the end reducing revenues available.

In closing, Mr, Chairman, let me say just one word about the deep concern that we have overf what appears to be a recent trend to use reconciliation to legislate important concepts or initiatives in the health area.

COBRA in the last reconciliation bill is an example of this.

NFIB feels strongly that reconciliation is not an appropriate place to enact such important and far-reaching initiatives where there is little opportunity for serious debate and for separate votes where Congress can consider important initiatives like this.

We urge you to resist these initiatives and to consider them in a manner which is conducive to proper consideration and debate.

Thank you very much, Mr. Chairman.

Senator BAUCUS. Thank you very much, Mr. Motley.

Next, we will hear from Mr. Paul Huard, who is Vice President for Taxation and Fiscal Policy of the National Association of Manufacturers.

[The prepared statement of Mr. Motley follows:]

# STATEMENT OF

## JOHN J. MOTLEY III
## DIRECTOR OF FEDERAL GOVERNMENTAL RELATIONS

## NFIB

Mr. Chairman, on behalf of the more than 500,000 small business owner-members of NFIB, I submit this statement for the official hearing record, outlining the concerns of our membership with respect to the committee's instructions to raise revenues for the Budget Reconciliation.

Polling of NFIB members on budgetary issues consistently indicates overwhelming agreement among small business owners that federal spending is out of control, that the nation's deficit is cause for alarm and is largely responsible for high interest rates and tight credit markets.

Despite concern over deficits, small business does not buy the charge that tax cuts and tax reform are the principal culprit, nor do they agree with extreme supply siders. Two thirds do not believe continued economic growth will eliminate the deficit, however there is virtual unanimity that a strong economy will reduce it.

Revenues have played a role in deficit reduction. According to a CBO analysis, total revenue increases since 1985 represent 22% of the 1987 deficit reduction, more than equal to the cuts in non-defense discretionary spending.

However, NFIB members are persistent in their opinion that deficit reductions should be achieved primarily through spending reductions. Preliminary results of our most recent Mandate ballot reveal that 71% of the NFIB membership want Congress to reduce the deficit through reductions in spending, not through new taxes or increases in current taxes.

Under the budget agreement recently reached, the House Ways and Means Committee is charged with finding some combination of tax increases or spending reductions to achieve budget savings of approximately $20 billion in fiscal 1988. Potential tax increases are always a concern to small business owners, and it is important that you know the impact on smaller firms of certain revenue raising options you are considering.

It is surely not necessary to remind the Committee about the massive tax reform exercise which was completed just last October. The Tax Reform Act of 1986 was the culmination of an exhaustive, two-year exercise. It may not be the most perfect document from the perspective of small business, but it was the best bill that could be achieved given the political and budgetary constraints that had to be met.

The Tax Reform Act of 1986 (TRA) represents the single largest reform of the Internal Revenue Code since the 1954 code revision. The Internal Revenue Service has just begun to release temporary guidance on its implementation, and the Congress has yet to consider a sizeable technical corrections bill.

Small business owners are deeply disturbed by the prospect of Congress substantively reopening tax reform; in particular there is great concern over reports that Congress may adjust the tax rates enacted in the TRA.

They are still confused about how tax reform affects them as both business owners and individual taxpayers. A significant new tax bill within six months of passage of major tax reform before that bill is even fully implemented is completely unwarranted.

Among the possible revenue options proposed by the Joint Committee on Taxation, the following items are of greatest concern to small business owners.

## Tax Rate Issues

Based on a very recent survey of NFIB members, small business owners wish to send Congress one very plain message:

DO NOT CHANGE THE TAX RATES PASSED IN TAX REFORM!

NFIB's support for tax reform was substantially based on lowering corporate and individual tax rates. Enactment of lower tax rates was the inducement for eliminating the investment tax credit--a particularly important tax incentive for small firms. Any attempt to change the rates will be seen as a breach of faith with the small business community

Tax rate changes include any of the following:

- Delay in implementation of the corporate or individual rates
- Proposing a surcharge on the corporate or individual rates

- A straight increase in the corporate or individual rates which were enacted in the Tax Reform Act of 1986

- Any changes in the indexing of tax rates.

Increases in tax rates would discriminate against small business owners because small business owners in the lowest tax brackets received the least amount of tax relief in the TRA. Prior to tax reform, a corporation with $25,000 or less of taxable income paid a 15% tax rate; the TRA did not change this rate. However, this taxpayer now no longer benefits from the investment tax credit or several other provisions he might have benefitted from under the previous Code.

A surcharge, contrary to popular belief, would be particularly unfair to small business. The result of a surcharge on the lowest bracket taxpayers would be an effective increase in tax rates. Such an increase would have a devastating impact on corporations with $25,000 or less in taxable income -- approximately 50% of all corporations in the United States.

Within the complex framework of tax rate reductions and reforms in the tax code, the structure of the reduced rates was discussed, and amendments were proposed and defeated by handsome margins in both the House and the Senate. Any revision of the rates so soon after passage of tax reform -- before any reasonable analysis can be made of the impact of tax reform on taxpayers -- is bad tax policy because it is bad economic policy.

Small business owners insist that tax rate increases not be a part of the debate over revenue raising in this budget reconciliation bill.

## Estate Taxes

Small businesses owners have consistently rated the estate tax issue as a high priority, their preference being that the estate tax be abolished. In both White House Conferences on Small Business, held in 1980 and 1986, estate tax issues were ranked very high among the list of concerns for small business owners from diverse industries, geographic areas, and among all income-producing categories.

Estate tax issues rank high in importance because to a small business owner, estate taxes too often have a direct and adverse effect on the owner's attempts to ensure the survival of the business. Continuation of a family-owned business after the owner's death compels a small business owner to be concerned with estate tax planning. The need for liquidity to protect the business translates into purchasing key man insurance and, to the extent possible, ensuring a line of succession in the business. This results in drains on capital reserves and hurts capital formation, consistently the biggest problem small firms face.

To a small business owner, whose primary concern is running his business, efforts to counteract the potential impact of estate taxes are counterproductive since they divert funds which could otherwise be used to buy more equipment or hire more employees, but which must now be used to buy life insurance and pay an estate tax consultant. In addition the small business owner sees the estate tax as the ultimate intrusion into his life: the small business owner's family is often intimately and inseparably involved in the business and is as responsible for its success as is the owner.

In 1985, estate and gift taxes accounted for less than 1% of the total collections of all taxes by the Internal Revenue Service, according to the Annual Report of the Commissioner and Chief Counsel of the IRS. In gross dollar terms, this represents collections of approximately $6.5 billion in 1985, an amount which has not varied much since 1980, when collections from estate taxes totalled a little more than $7 billion.

Clearly not much revenue is being collected from this tax, and no analysis has ever been made to determine its efficiency as a revenue-raising tool. The fact that less than 1% of all federal revenues are being raised by estate taxes should lead one to at least question the efficiency of the estate tax as a tool to raise significant amounts of revenues.

The estate tax issue is not a pitting of the rich vs. the poor. The distaste of the small business owner for estate tax issues is based on concerns for a portion of the tax code which wastes resources and compels the liquidation of the very family-owned businesses Congress so steadfastly claims it is trying to encourage.

Big dollars are not taxed under the estate taxes because wealthy families are protected by estate tax advisors who carefully plan transfers and trusts for these wealthy families.

Small businesses are always hurt the most by estate taxes. Small business owners typically do not engage estate planners for sophisticated planning. They prefer to put their resources and energies into their businesses with the hope of leaving them to their families.

What typically occurs, however, is that after the owner's death, the business -- which is usually the primary estate asset -- must be placed on the sales block, usually at distressed prices, to pay the estate taxes. Estate tax is not just a tax to small business owners; it is an insidious device which taxes their life's work at death.

The liquidity of small estates has been a key issue in every debate over changes in estate tax rules. Proponents of changes in the estate tax rules claim that increasing estate tax rates is equitable, but these proponents are not looking behind the rhetoric of the issue to determine who is really affected.

Among the options being considered by the Committee are estate tax rate increases and reductions in the unified credit, repeal of the stepped up basis rule, and imposition of an estate tax on the net value of an estate. None of these are acceptable options to the small business community.

The Economic Recovery Tax Act of 1981 had several provisions on estate taxes, most of which have finally become fully implemented just this year. Once again Congress would be changing the rules just as everyone becomes acclimated to them. In addition, the increases in estate tax rates would hurt small business, not large estates.

Federal Unemployment Tax Act (FUTA Provisions)

Two options cited by the Joint Committee on Taxation for raising revenues affect FUTA taxes: indexing the FUTA wage base, and extending the 0.2% FUTA surcharge which is due to expire this year.

Unemployment compensation tax rates are based on the employer's experience vis-a-vis his/her industry counterparts; this system of experience-based ratings is the cornerstone upon which the whole U.C. system is based. Taxes are deposited in state and federal funds to be used specifically for U.C benefit payments for workers.

The proposal for increasing the wage base would result in newly-generated revenues which technically could not be used for anything other than FUTA. This proposal both violates the longstanding concept of experience-based rates in the unemployment compensation system, and would not generate revenues which could be used to reduce the deficit. Therefore it is simply a payroll tax increase on employers which will only result in the creation of a big pool of money in the U.C. funds.

The second proposal under the FUTA section is a proposal for extending a surcharge imposed on FUTA tax rates. This proposal is similarly misguided. The surcharge on FUTA taxes was implemented in 1976 for a specific reason: to help states that had borrowed heavily during the high unemployment periods of the early 1980's pay off the debt owed the Treasury. As of October 1, the states will have paid off their debt to the federal government.

The surcharge was intended as a temporary tax to cover a specific problem. To extend the surtax now is a breach of faith with the employers of our nation. Never again will they accept a "temporary" tax for whatever purpose, because temporary can become permanent too easily when Congress is searching for additional revenues.

What is particularly disturbing about these two proposals is that payroll tax increases are the worst kind of tax increase Congress can impose because they increase the cost of labor directly, thereby reducing productivity and, in the short term, hurting job creation.

The membership of NFIB strongly opposes both of the FUTA provisions listed in the options list.

## Additional Issues

In addition to the options we have already noted, the following options are also opposed by the small business community.

## A Value Added Tax (VAT)

NFIB would be very concerned if, in the context of a budget reconciliation bill, Congress seriously considered imposing a Value Added Tax. In 1986, NFIB cosponsored a study of the impact of the VAT on small businesses in Europe. This study, entitled VAT and Small Business: European Experience and Implications for North America, contains a series of findings the Committee would find most enlighting.

Of the major findings of this study, one is most disturbing to NFIB:

> Both the business costs of complying with VAT and the government costs of administration are regressive with respect to size of firm. Measures typically taken to counteract this seem to be wholly or partially self-defeating. VAT and small business do not go well together.

In several Mandate polls on the issue of a consumption tax or a VAT, the NFIB membership consistently opposed a VAT or consumption tax when it was proposed as a tradeoff for some other tax. As a free standing new additional tax, there is no question about small business' strong opposition.

Imposition of a consumption tax or a VAT would have very broad consequences for our economy. It is not a decision which should be made in haste in the context of a budget reconciliation measure, and it certainly is ill advised before full implementation of the Tax Reform Act.

## Health Issues

In 1986 NFIB surveyed its members on the top problems they face in running their businesses. This survey, known as the Problems and Priorities Survey, revealed that health insurance costs was their number one problem in 1986.

This is no great surprise, as the inflation rate in the health care field has been more than double that of the rest of the economy. These higher costs are rapidly translating into higher insurance premiums, and the spiral in health insurance costs continues upward.

Proposals to mandate increased coverages, by requiring catastrophic coverage for employees, implementing state risk pools, or similar ideas, are the wrong way to approach this issue. We would encourage this Committee not to take any actions in this area until a full examination of all health care issues has been accomplished.

## Capital Gains Taxes

One of the more controversial decisions made in tax reform was to eliminate the preferential tax rate on capital gains and to treat income from the sale of capital assets as ordinary income.

Among the proposals listed in the JCT option book is a proposal for a reduction in the capital gains tax rate. As a result sales of capital assets would be taxed at a rate of 15% instead of the current rate of 28%. This rate change for capital gains would restore the preferential rate on capital gains which existed prior to enactment of tax reform.

Small business has traditionally favored a preferential tax rate on long-term capital gains to promote the benefits of long-term investment. Traditionally investors looking to promote small business have little in the way of incentives for making these investments. Investments are long term, with highly questionable liquidity, and the risk of no return or a total loss is fairly high. For these reasons the preferential rate on long term capital gains is believed to be a real inducement to invest in small firms.

Clear evidence exists in the form of studies performed by the Department of Treasury on the impact of previous reductions in the rate of capital gains. The results of the Steiger Amendment in the 1978 tax bill resulted in substantial revenue gains. There is no reason to believe that restoring the capital gains differential will not have a similar effect.

Ensuring adequate levels of capital for small business is an issue which needs to be considered. Tax reform eliminated many of the incentives for investment which previously existed. The emphasis of tax reform was to encourage investors to invest for income, not tax benefits. Small business investment would certainly be encouraged by reducing the tax rate on capital gains, and we would encourage the Committee to include such a reduction in its Reconciliation bill.

NFIB supports a capital gains preference because it is a pro-growth way to reduce the deficit. A capital gains tax cut will not only encourage investment in small business, it will also increase economic activity across a broad spectrum and raise revenues to further reduce the deficit. From NFIB's standpoint, it is much sounder economic policy to raise revenue by cutting capital gains taxes than by raising other taxes that would damper economic activity and eventually reduce total revenues.

## STATEMENT OF PAUL HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Mr. HUARD. Thank you for the opportunity to participate in this important inquiry and to present the views of our more than 13,500 members who employ 85 percent of all manufacturing workers.

NAM's views on options to increased taxes are as follows. With the sole exception of increased receipts derived from lowering capital gains tax rates, we oppose any change that would increase Federal revenues from individual or corporate income taxes.

With no exceptions at all, we oppose any change that would increase Federal revenues from selectively imposed excise taxes, from payroll taxes on private sector employers or private sector employees, or from estate and gift taxes.

Finally, our advice continues to be that the best technique for lowering deficits is reduction of the overall growth rate of Federal spending and not the enactment of new or increased taxes.

If Congress is nevertheless determined to ignore this advice and raise additional Federal tax revenues, then we believe that this should be done only by means of a general consumption tax imposed at a uniform rate on the broadest possible base of goods and services.

Let me elaborate now on a few of the points I have just made.

First, as to income tax changes, we believe any further increase in income tax burdens is wholly unjustified. Reliance on income taxation is already excessive.

Under present law, the Federal government raised nearly 92 percent of its total revenues from income and payroll taxes; in other words, by taxing income from work, savings, and investment.

Taxes on consumption, on the other hand, account for only a little over five percent of the total. Compared to the more balanced ratios that prevail in other developed countries, our Federal tax system indulges consumption and penalizes labor and thrift to a degree that is very nearly scandalous.

This imbalance needs correction, not further aggravation.

The argument is often heard that the Federal income tax system should be made more progressive and based on ability to pay. These are polite euphanisms for soaking the rich and the corporations, an activity which apparently provides considerable emotion gratification to some, but which cannot be justified on the facts.

The fact is that the top 10 percent of individual taxpayers pay about half the total individual Federal income tax burden. This, in our view, is more than amply progressive.

As to corporations, the fact is that corporations are overtaxed, not undertaxed, relative to individuals.

It is true, of course, that individuals pay almost four times as much income tax as corporations. Personal income, however, is nearly 12 times as large as corporate profits, nearly $3.6 trillion versus about $300 billion.

The relevant fact emerging from all this is that the effective rate of Federal income taxation for corporations is around triple that of individuals, in approximate terms, 33 percent versus 11 percent.

This gross disparity, incidentally, also prevailed prior to the Tax Reform Act of 1986. Indeed, for at least several decades prior to the 1986 reform legislation, the effective corporate rate was consistently at least twice that of individuals.

The 1986 changes, which increased corporate taxes some $120 billion over five years to pay for individual cuts of about the same amount over the same period, merely serve to make an already bad situation quite a bit worse.

Let me comment basically on the ways income taxes can be raised. There are essentially only two, reflecting the fact that the tax engine has only two moving parts, the rate and the base.

To get more revenue, you must either increase the rates or broaden the base. Either approach, in our view, is objectionable at this time.

Lower tax rates were the explicitly promised—let me emphasize and repeat that—explicitly promised tradeoff for the massive base broadening that took place in the Tax Reform Act of 1986.

Congress should not erode what credibility it has in the realm of tax policy by brazenly renegging on a commitment that is not yet 10 months old.

As to base broadening, this is a short end term for further entrusting the Internal Revenue Code with limitations, exceptions, limitations within limitations, exceptions to exceptions, and multiple alternate calculations—all designed to milk just a little more revenue out of the system.

We believe the very last thing taxpayers need right now is another dosage of the death by a thousand cuts that was administered to them in 1982, again in 1984, and yet again in 1986.

The income tax laws have become so hopelessly convoluted that they are beyond the ability of many taxpayers to understand; perhaps mercifully, they might also be beyond the ability of many IRS personnel to enforce.

In any event, possibly nothing would be of greater benefit to both taxpayers and the Treasury Department than if Congress were to make no further changes at all in the Internal Revenue Code for a period of five to ten years.

On the subject of consumption taxes, we find selective excise taxes objectionable for two reasons. First, they are inherently distortionary, unfairly raising the cost of taxed goods and services relative to those that are untaxed.

Second, they are undeniably regressive in many cases, and it is simply not feasible to adjust for this regressivity.

A broad-based general consumption tax, on the other hand, would be neutral rather than distortionary and can readily be corrected for regressivity.

I emphasize again, however, that any tax increase is a vastly inferior choice to additional spending cuts.

In closing, I would like to make one observation. We have heard some complaints this morning about the excessive 1981 tax cuts and how there is about $136 billion of that left.

I would point out that that entire amount accrues to the benefit of individuals, mostly in the lower and middle income brackets.

The amount that accrues to corporations is exactly zero. Indeed, corporations had given back all of the 1981 tax cut before the enactment of the Tax Reform Act of 1986.

Thank you.

Senator BAUCUS. Thank you very much for your testimony.

[The prepared statement of Mr. Huard follows:]

# TESTIMONY
# OF THE
# NATIONAL ASSOCIATION OF MANUFACTURERS

## I. Introduction

Candor requires me to note that, when the conference agreement on H.Con.Res. 93 reached the floor of the House and Senate, NAM wrote each member of Congress urging a negative vote. Although we continue to believe the nation would be better off had the resolution been defeated, that legislative battle has now been fought and lost. And while some have expressed doubts about the wisdom of developing a painfully difficult tax bill that may well be vetoed, we believe that by embarking expeditiously on such development, the Committee has exercised the only responsible choice open to it. You are to be commended for that.

Let me turn now to the subject matter of this hearing, which is set forth in a 291-page pamphlet entitled "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means." (JCS-17-87), June 25, 1987. This pamphlet was prepared by the staff of the Joint Committee on Taxation in conjunction with the staff of the House Ways and Means Committee. We acknowledge the fact that it is intended simply as a list for discussion purposes, and is not to be construed as a recommendation of the Joint Committee staff, or of the staff or any member of this Committee or of the House Ways and Means Committee.

In the balance of this testimony, I will group the listed options into six generic categories, and explain our views on each such category. For the most part, the views stated will apply with equal force to all items within the category. In some cases, however, I will add comments directed only at a particular item within the category. The six broad categories I will comment on are: (a) income taxes; (b) selective excise taxes; (c) general consumption taxes; (d) employment taxes; (e) estate and gift taxes; and (f) miscellaneous non-tax revenue sources.

## II. Opposition to Income Tax Increases

With one exception (see p.7), NAM opposes any option that would increase federal individual or corporate income tax revenues. More specifically, we would oppose and urge the President to veto any bill having one or more provisions which would:

- — extend, for any period, any individual or corporate tax rate intended under the Tax Reform Act of 1986 to be transitional in nature; or
- — increase, for any period at any bracket level, any marginal tax rate for either individuals or corporations that was intended under the Tax Reform Act of 1986 to be a permanent rate; or
- — impose, on any individual or corporate income tax liability arising under existing law, any surtax whatsoever, regardless of the rate or duration thereof; or
- — repeal or curtail, for any period, any credit, deduction, exclusion or exemption available under existing federal individual or corporate income tax law; or
- — repeal, curtail or otherwise modify, for any period, any existing definition or accounting rule in a manner that would increase the federal individual or corporate income tax liability of any taxpayer.

Our reasons for opposing any individual or corporate income tax increase of any kind are summarized below:

Reliance on Income Taxation Is Already Excessive. Under present law, the federal government raises nearly 92% of its revenues from income and payroll taxes, in other words, by taxing income from work, savings and investment. Taxes on consumption, on the other hand, account for only a little over 5% of the total. Compared to the much more balanced ratios that prevail in other developed countries, our federal tax system indulges consumption and penalizes labor and thrift to a degree that is very nearly scandalous. Further revision of the federal tax system—whether or not such revision generates any net increase in revenues—should be directed at redressing this imbalance by shifting the burden of taxation more onto consumption.

Congress Should Not Renege on Its Tax Reform Promises. Reduction in the marginal rates of taxation on both individual and corporate income was the explicitly-promised tradeoff for the massive base-broadening which took place under the Tax Reform Act of 1986. Congress should not further erode its credibility by brazenly reneging on that promise less ten months after its enactment. This rationale applies to all increases in marginal rates, whether direct or circuitous. In other words, we are opposed not only to outright increases in the existing marginal rate structure, but also to "freezes" in transitional rates, the addition of new rates and brackets, or the imposition of surtaxes.

Income Taxes Already Are Sufficiently Progressive. The argument is often heard that the federal income tax system should be more "equitable" and "progressive." and based on "ability to pay." These are thinly-disguised code words for raising taxes on corporations and upper-income individuals. While doing this may provide emotional gratification to some, it cannot be justified on the basis of the facts.

It is true, for example, that individuals pay almost four times as much federal income tax as corporations. Personal income, however, is nearly 12 times as large as corporate profits—nearly $3.6 trillion versus about $300 billion. The relevant fact emerging from all this is that the effective rate of federal income taxation for corporations is around triple that of individuals [in approximate terms, 33% vs. 11%]. This gross disparity, incidentally, also prevailed prior to the Tax Reform Act of 1986. Indeed, for at least several decades prior to the enactment of the 1986 reform legislation, the effective corporate rate was consistently at least twice that of individuals. The 1986 changes, which increased corporate income taxes by some $120 billion over 1987-90 to pay for individual tax cuts of about the same amount over the same period, merely served to make an already bad situation quite a bit worse.

As regards individuals, the plain fact is that, before and after the Tax Reform Act of 1986, the top 10% of individual taxpayers pay about 50% of the total individual income tax burden. This degree of progressivity is, in our view, more than ample. Moreover, the 1986 Act has already added an unbelievable amount of clutter to the Internal Revenue Code in the form of complex rules and phase-outs designed to limit the amount of tax relief flowing to upper-income taxpayers. This is a problem that needs no further aggravation. Finally, hindsight has demonstrated, both with regard to capital gains tax rates and the marginal rates of tax on ordinary income, that lowering such rates actually results in increased tax receipts from upper-bracket taxpayers.

The Income Tax System Should Tax Income, Not Gross Receipts. The Congress in recent years has displayed a regrettable tendency to raise revenue by denying or limiting deductions for ordinary and necessary business expenses. The current limitations on deductibility of meal and entertainment expenses are but one example of this. Another is the proposed option that would deny a deduction for 20% of advertising costs.

NAM believes it is essential to preserve the traditional concept that, as applied to business taxpayers, the federal income tax system is a tax on net income, i.e., on gross income less all costs incurred in producing such income.

Denial of a deduction for all or part of costs incurred in the ordinary course of trade or business tends to change the nature of the system from a tax on income to a tax on gross receipts. Gross receipts are an inappropriate and inequitable base for the imposition of federal taxes on business income, leading to widely disparate tax burdens among taxpayers.

We therefore oppose all options that would repeal or curtail deductions for ordinary and necessary business expenses, whether specifically targeted at a particular type of expenditure or included as part of across-the-board cutbacks on alleged "tax preferences." Singling out one or more types of business expenditure for nondeductible treatment—in full or in part—is objectionable in principle. Further, it is especially deplorable when the underlying motivation is a naked attempt to extract additional revenue, devoid of any consideration for the reasoned application of fair and consistent tax policy principles.

**Additional Complexity Is Clearly Undesirable**. About the last thing needed just now by most taxpayers is another dosage of the "Death by a Thousand Cuts," as was administered to them in the tax laws of 1982, 1984 and 1986. The cumulative effect these statutes has been to subordinate sound tax policy principles to revenue demands and political considerations to such a degree that the system may be on the verge of foundering. In area after area, the need to extract just a little more revenue has resulted in rule changes so byzantine and convoluted that they are beyond the ability of many taxpayers to understand and, in some cases, perhaps beyond the ability of many IRS personnel to enforce.

If one thing is clear, it is that the almost continuous process of encrusting the Internal Revenue Code with more exceptions to exceptions, more limitations within limitations, more alternative calculations applied to the same set of numbers, etc. should be stopped dead in its tracks. Possibly nothing would be of greater benefit to both taxpayers and the Treasury than if Congress made no changes whatsover in the federal income tax laws for a period of five to ten years. And whenever further changes are made, the palpable need for simplification—a goal which unfortunately dropped completely out of sight during the 1985-86 "reform" process--should be a major criterion against which all future changes are measured.

One Small Exception After All. Under the Tax Reform Act of 1986, long-term capital gains will after 1987 be taxed at the same rate as ordinary income. NAM has consistently supported use of a preferentially lower tax rate on capital gains, both as a means of compensating investors for risk-taking and as a device to mitigate the taxation of purely illusory gains resulting from inflation. Past results strongly indicate that the Treasury's receipts from capital gains taxes can actually be expected to increase when the capital gains tax rate is lowered. Accordingly, a significant reduction in the current capital gains tax rate, say to 15% as suggested at page 242 of the June 25 staff options pamphlet, is the one—and only—revenue-raising income tax change that NAM would support. Contemporaneously with such a change, Congress should consider whether the holding period should be lengthened somewhat so as not to promote short-term speculation.

## III. Opposition to Selective Excise Taxes

NAM opposes without exception any option that would increase the amount of federal revenue derived from selectively-imposed excise taxes. Specifically, we would oppose and urge the President to veto any bill that would: increase any selectively-imposed excise tax now in effect; or extend any such tax now in effect but due to expire; or create any new selectively-imposed excise tax.

Our reasons for opposing any further expansion of the system of selective federal excise taxes are summarized below:

**Consumption Taxation Should Be Neutral.** A desire to make the income tax system more neutral was one of the driving forces behind the Tax Reform Act of 1986. NAM believes the principle of neutrality should also be applied to the taxation of consumption. As a matter of long-standing policy, we are fundamentally opposed to taxes that are levied only on particular sectors of the economy. Such taxes are inherently distortionary because they raise the price of taxed goods and services relative to those that are untaxed. In some cases, for example oil import fees or gasoline taxes, wide variances in consumption patterns can result in geographic discrimination as well.

Furthermore, to the extent that deficit reduction is the motivating factor for seeking new revenues, selective excises are an inappropriate source of such revenues. Our deficit problem is national in scope, affecting all sectors of the economy. The same should be true of the solution. Particular industries or activities should not be singled out and required to bear the burden of deficit reduction while other sectors are left untouched.

If consumption taxation is to be employed as a deficit reduction tool, then a general consumption tax is a far superior method, because it would apply more broadly and evenly throughout the economy. [See Part IV of this testimony.] Indeed, if a general consumption tax system is adopted, it should not be superimposed on the existing system of selective excise taxes. Instead, to achieve fairness and neutrality, all such selective excises should then be repealed.

**Regressivity of Selective Excises Cannot Be Adjusted For.** It is now generally recognized that many of the selectively-imposed excises currently in use are highly regressive in nature, because the taxed goods or services are widely consumed or utilized by low-income individuals. Such regressivity is generally viewed as an undesirable feature. However, because of the variations in the consumption patterns of selectively-taxed items, there is no feasible method for directing relief to those low-income consumers actually impacted. If, on the other hand, all consumption is taxed, then the universality of the impact makes it possible to correct the regressivity of such a system in a manner that is both effective and efficient. [See Part IV of this testimony.]

Excise Taxes Should Not Be Regulatory Devices. Certain excise taxes now in use are viewed by some as legitimate techniques for discouraging the consumption of the taxed items. Not surprisingly, these are sometimes called "sin" taxes. Recently, it has become fashionable to argue that these "sin" taxes should further be increased to recover the "costs" that the taxed items are asserted to impose on society. Whether or not the assertion is true, the argument is an exceedingly dangerous one because of its broad potential applicability.

For example, a certain number of deaths, injuries or illesses each year can be associated with traffic accidents, or with heart and circulatory problems, or with hypertension, and so on. These proximate causes can in turn be associated with automobiles, cholesterol, and salt, respectively. Does this mean we should have an excise tax on cars and on eggs? Should all food items be subject to a differential excise based on salt content? I suggest the answer is unambiguously no. Not only is the relationship between a taxed item and societal costs sometimes arguable, the calculation of such costs is itself a highly speculative exercise, all of which should make it abundantly clear that what we have here is a wholly imprecise--and therefore improper--basis for assessing taxes.

Certain Excises Would Adversely Affect Competitiveness. Many of the excise taxes now in effect are applied to finished goods and as a result do not affect the cost of producing such goods. This is not the case with certain major new excises now being considered, most notably oil import fees and various forms of energy taxes. These would increase industrial production costs because they would apply to feedstocks consumed and/or to energy utilized in the production process. Thus, an additional ground for opposing oil and energy-related taxes is that imposition of such taxes would adversely affect our ability to produce competitively-priced goods in both domestic and world markets.

## IV. Position on a General Consumption Tax System

NAM believes that the key to lowering deficits must be significant reductions in the growth of federal spending across the board and not the enactment of new or increased taxes. If in addition to spending reductions, however, Congress is nevertheless determined also to increase federal tax revenues as part of a deficit reduction program, then the fairest and least counterproductive approach is the implementation of a general consumption tax system. A general consumption tax should be designed in accordance with the following principles:

A Transaction-Based Tax Is Best. A general tax on consumption should apply on a transaction basis, i.e., it should be imposed on an ad valorem basis when a taxable product or service changes hands. Either a retail sales tax or a value added tax ("VAT") would satisfy this criterion, the latter being no more than a multi-stage variation of the former. Indirect methods, such as the so-called subtractive method tax described in the staff options pamphlet [pp. 79-80] are less attractive fpr several reasons. One is that the selling firm does not compute the tax on the basis of a specific sale to a buyer, but rather aggregates all sales and all purchases, subtracts the latter total from the former, and pays the tax on the net difference. In such a situation, the firm's ability to pass the tax forward to any specific buyer must be rated as suspect. Since the whole idea of a consumption tax is to pass the tax forward to ultimate consumers, and not to increase the costs of industrial production, this is a considerable drawback. From an enforcement standpoint, another consideration is that a VAT, which is an "invoice and credit method" type of tax, is thought to leave a much better audit trail throughout the production/distribution chain.

It Should Be Broadly-Based and Neutral. A general consumption tax should apply at a single uniform rate to the broadest possible base of taxable goods and services, so as to spread its burden equitably across the entire economy, while at the same time permitting the tax rate to be as low as possible given the amount of revenue intended to be raised. Omission of the service sector from the tax base, as occurs under many state sales tax systems, would be unfair, requiring higher taxes on a narrower base and disproportionately impacting those groups that consume more goods than services. A multiplicity of different rates, in addition to seriously eroding the goal of neutrality, would also add undesirable complexity. And, if a general consumption tax is enacted, then as previously noted, the goal of neutrality will be most fully achieved if at the same time all existing selective excise taxes are repealed.

It Should Apply to Full Value and Be Visible. A general consumption tax should apply to the full value of taxable goods and services, up to and including retail value, and the tax should be separately stated and readily identifiable at that level. Transaction-based tax systems that omit the retail level will have an unnecessarily narrow tax base. The need for the tax to be visible at the retail level is obvious: taxpayers should know how much they are paying for the cost of being governed. Hidden taxes are too easily raised. This last consideration militates heavily against usage of a subtractive method tax, which is more likely to get buried in the overhead costs of producers and distributors.

**It Can and Should Be Adjusted for Regressivity**. There is no doubt that a general consumption tax system can be regressive. Fortunately, the system's regressivity can be adjusted for in a manner that is both effective and efficient, *i.e.*, in such a way that impacted low-income consumers get the relief that is intended for them and no unintended benefits are conferred on others. This can be achieved by providing, through the income tax system, a refundable credit that is phased out above certain income levels. [An obvious analogy is the earned income credit under present law.]

As previously noted, it is impossible to adjust for regressive impact of the existing federal excise taxes. It is simply not feasible, on a person-by-person basis, to match up the two relevant facts—whether the person bought the taxed item and, if so, whether his or her income level is such as to warrant relief—and then to provide the desired relief.

Under a general consumption tax system, the universal applicability of the tax to all consumption eliminates any need to determine if a low-income consumer was impacted--the existence of such impact may safely be assumed. Whether and how much relief is available is determined on the basis of a person's income tax return. Because of the phase-out provision, higher income individuals not needing relief would not get any. Because the credit would be refundable, those with incomes so low as to have little or no tax liability would still get the full amount of intended relief.

There undoubtedly are other ways to adjust a general consumption tax system so as to correct the problem of regressivity. One common approach is to exclude certain items from the tax. Food and medicine are typical exclusions under many state sales tax systems. On the assumption that one can reach a reasonably accurate determination of what low-income groups consume, this technique will tend to achieve the desired results. Exclusions, however, erode the neutrality of the system and moreover are highly inefficient because they benefit all income levels, including those perfectly able to stand the burden of a general consumption tax.

Taxpayers Other Than Ultimate Consumers Must Get a Credit for Taxes Paid. If a general consumption tax is levied at multiple points in the production and distribution process, credits for taxes paid must be allowed to prevent the pyramiding of taxes. This is not a problem with a retail sales tax, since there is only one point of collection. Such credits typically are allowed under the "invoice and credit method" VAT described in the staff options pamphlet. [p. 79]

If such credits are not allowed, the government will collect much more than the nominal rate of tax. For example, suppose an article is sold successively by a manufacturer, wholesaler and retailer, for $20, $40 and $80, respectively, and the nominal rate of tax is 5%. Under an invoice and credit method VAT, the manufacturer will collect and remit $1; the distributor will pay $1, collect $2 and remit the difference of $1; the retailer will pay $2, collect $4 and remit the difference of $2. The government gets a grand total of $4, exactly what it would get under a straight 5% retail sales tax. Either way, the ultimate consumer pays $84 for his purchase. Without the credits at the intermediate points of the chain, however, the government would collect a total of $7, an effective rate of nearly 9% even though the nominal rate is 5%.

It Should Not Apply to Exports. Taxes paid by a manufacturer are part of the cost of doing business and, under ordinary circumstances, are reflected in the price of the product. Many of our industrial competitors, however, finance a significant part of the costs of their governments with VAT-type taxes which are rebatable on exports. The major taxes paid by U.S. manufacturers are payroll and corporate income taxes which, although they may make up part of a product's cost, are not rebatable if that product is exported. This disparity unquestionably puts U.S.-based producers at a competitive disadvantage in export markets.

Nevertheless, these are the rules we have agreed to play by as signatories to the General Agreement on Tariffs and Trade ("GATT"). Our trading partners are no fools, and therefore are not about to agree to any change in the GATT rules that would wipe out their advantage. We do have the option, however, of financing a greater part of the cost of our federal government with taxes that under GATT rules are rebatable on exports. A broad-based general consumption tax would be just such a tax. An even greater boost for export competitiveness could be achieved if part of the revenues from a general consumption tax system were utilized to permit reductions in payroll and corporate income taxes.

Consumption Tax Revenues Should Not Be Used To Finance Additional Spending. Revenues derived from a general consumption tax system should be used primarily to reduce the federal deficit and no part of such revenues should be used to finance additional government spending. Simply described, our deficit problem is that the national government takes in revenues totalling around 19% to 20% of GNP, but spends at a rate of 23% to 24% of GNP. New tax revenues should be used principally to close this gap, not to further inflate an already excessive level of government outlays.

It is also desirable that a significant portion of these new revenues be applied to reduce existing federal taxes. Two particular applications come to mind immediately: (1) enactment of a refundable credit under the individual income tax system to provide the regressivity adjustment discussed previously; and (2) repeal of all existing selective excise taxes to prevent double taxation and achieve neutrality. Other applications might be considered with an eye to further improving the interplay between the individual and corporate income tax systems. If, for example, the top corporate rate were lowered to match the top individual rate, and the systems were properly integrated so that corporate earnings paid out as dividends to shareholders were not doubly taxed, much of the gamesmanship now surrounding the form of doing business [e.g., corporation vs. partnership] simply would not occur.

### Discussion of Staff Options

The brief discussion in the staff options pamphlet [pp. 79-81] of a possible general consumption tax system identifies two major variants. One is a value added tax, an "invoice and credit" method under which every taxpayer save the ultimate consumer collects the VAT tax on its sales but reduces the amount it remits to the government by taking a credit for the amount of VAT paid on its purchases.

The other option is a business alternative minimum tax ("BAMT"), a subtractive method under which each taxpayer in the production/distribution chain—save again the ultimate consumer—subtracts from its aggregate sales the amount of its aggregate purchases from other firms, and pays the prescribed BAMT rate on the difference. Payroll and income taxes could be allowed as credits against BAMT liability, thus giving rise to the "minimum tax" nomenclature.

When the VAT and BAMT are measured against the design criteria enumerated above, it is clear that the VAT is the hands-down winner. The VAT satisfies all the criteria whereas the BAMT fails in a number of important areas: (a) it is a hidden tax which could not be made visible to the ultimate consumer; (b) its impact on ultimate consumers is very difficult to assess, thus complicating the task of designing an effective and efficient adjustment for regressivity; and (c) it is not transaction-based, so that it is doubtful that it can be uniformly passed on to consumers and that, for compliance purposes, it will give rise to as good an audit trail as a VAT. Moreover, as the staff options pamphlet notes, the allowance of credits against BAMT liability for income and payroll taxes paid may well be a GATT violation.

## V. Opposition to Employment Tax Increases

NAM opposes without exception, and would urge the President to veto, any change that would increase the employment tax burden of either private sector employers or private sector employees. Payroll tax levels are already excessive and contribute significantly to the competitiveness problems of many employers. The unceasing rise of such taxes throughout this decade has, for many employees, completely negated any benefit from the tax rate cuts enacted in 1981 and 1986.

In the case of both FICA and FUTA taxes, there is no demonstrable need to augment the trust funds to which such taxes are dedicated. The temporary 0.2% component of the FUTA tax that will expire after 1987 has fulfilled its purpose and is no longer needed. It should therefore be allowed to expire as scheduled.

The proposed indexing of the FUTA wage base is also objectionable. This change would increase revenues not only at the federal level but also in 17 states and the Commonwealth of Puerto Rico. In many of these jurisdictions the funds would simply be unneeded. In California, for example, the state unemployment compensation system has a surplus of several billion dollars. We believe that additional unemployment taxes should be raised only in response to specific unemployment compensation needs, not in response to general revenue concerns arising out of the federal budget deficit situation.

We express no opinion as to the advisability of extending the Medicare payroll tax to all State and local government employees.

## VI. Opposition to Estate and Gift Tax Increases

We oppose without exception, and would urge the President to veto, any change that would increase federal estate and gift tax revenues. Such taxes have an adverse effect upon the capital formation and initiative that are so necessary to industrial activity and the expansion of employment opportunities. Also, the imposition of such taxes often leads to the forced sale and breakup of family-held businesses. Accordingly, NAM's long-term policy objective in this area is to see estate and gift taxes removed entirely from federal use.

We are particularly distressed to see Congress once again considering repeal of the "stepped up basis" rule and other devices for extracting revenue from appreciated assets passing from a decedent. Congress committed a major policy error last year by significantly increasing capital gains taxes on sales or exchanges of assets occurring during a taxpayer's lifetime. It should not further compound this mistake by attempting to tax appreciated property passing at death. In many instances of property held for long periods, the so-called "appreciation" may be wholly illusory, i.e., the result of inflation, and the property may actually be worth less in constant dollars than when it was originally acquired.

## VII. Positions on Miscellaneous Non-Tax Revenue Sources

A number of non-tax revenue increases are under consideration. One of these is a significant increase in the amount of premiums paid to the Pension Benefit Guaranty Corporation. While NAM recognizes that PBGC premiums will have to be increased, we are strong supporters of the concept that such premiums should be risk-related.

At this time, we express no position for or against the concept of raising revenue through the imposition of so-called "user fees."

Similarly, we express no position for or against the concept of increasing receipts through the sale of government assets. NAM has no quarrel with asset sales that can be justified on grounds independent of the need to reduce the federal deficit. It should be noted, however, that the stock of salable government assets is ultimately depletable and, moreover, that each such sale is a non-recurring event that does nothing to remedy the long-term imbalance between revenues and outlays.

Senator **Baucus**. To a large degree—and I mean this respectfully—each of you gave somewhat predictable testimony, that is, each of you represents a certain organization. Your constituency, therefore, has a certain point of view.

You work for those constituencies like good advocates representing the constituents' point of view. You have very forcefully and very articulately stated those points of view. It was somewhat predictable, which is not to say that it is wrong. It is the point of view that you have.

It reminds me a little of the Iran-Contra hearings we have been having. Different people have different points of view on what we should be doing in Central America.

Now, as I listened to you, I was struck with your constituents' points of view. And I am wondering, as we look down the road and look into the next century, and we ask ourselves: Where do we want to be as Americans, particularly economically, as well as militarily and politically?

I think most Americans are probably more concerned about where we are going to be in the next century than they are about the short term.

What I am getting at is, putting aside your constituents' somewhat narrower points of view, if we want to be more competitive in the future, if we want to have relatively lower capital costs so that we can invest more in America with jobs for Americans, if we want more jobs in America, and if we wanted to be more competitive than we are now, most people think we should get our deficit reduced.

We should do what we can as Americans to get our Federal deficit reduced. We have heard lots of witnesses, time and time again, tell us how important it is to get the Federal budget deficit down.

Our Federal deficit eats up two-thirds of total private savings in this country.

My question is: What are we going to do about that?

Before I ask the question more precisely, I think it is only fair to conclude that this Congress this year is probably not going to go back and reopen the Tax Reform Act.

The Congress has been through that. The American people have been through that. Time after time, we hear people say: Don't keep changing the tax laws all the time. Let's put something in place and let it work its will for a while; and let's see what works and what doesn't work. Don't keep changing it all the time because people abhor uncertainty.

In addition, we are probably not going to go back and enact a consumption tax this year. I doubt that we will next year.

I think any significant changes in the tax code, if they occur, will [illegible] in the next Administration.

So, I would like you to tell me—looking at a long-term—and recognizing that we are not going to have any significant changes in the tax code this year, and further recognizing that we are going to have to raise some revenue, most economists tell us that it is better to raise some revenue to get the deficit reduced than it is not to raise any revenue and have the deficit reduced less.

Most economists say we have got to reduce the deficit by about $30 to $36 billion if we can. It will probably take some mixture of spending cuts and revenue raising.

This committee has more jurisdiction politically over the revenue side than the spending side. So, I would like you to tell me which of the ways of raising revenues make the most sense, both from our long-term competitive point of view and realizing we are not going to go back this year and open up the tax code.

So, I am just going to go down the list. I am going to ask you to rate them on a scale of one to ten—ten being the most optimal, one being least optimal. I would ask you to rate them, please, from the long-term competitive point of view and recognizing that we can't go back and reopen the tax code.

If you want to make a short comment, that is fine, too.

This is just in random order. First is raising the income tax, either surcharge or delayed reduction of the rates. On a scale of one to ten, we will start with you, Mr. Huard.

Mr. HUARD. Ten, I gather, is a favorable rating?

Senator BAUCUS. Ten is the most favorable. Yes.

Mr. HUARD. One.

Mr. RAHN. One.

Mr. OSWALD. Senator, I wouldn't be for raising everyone's income tax, but I think the very wealthiest in our society have had the largest reductions and could share in the burden. And I would be for not dropping their tax in the manner that is scheduled for 1988.

Senator BAUCUS. What number is that?

Mr. OSWALD. For that part of the income tax, I would put it at number ten. For changing all income taxes, as I would be against that and I would apply a similar standard where you wouldn't have a high—where you would leave the current tax for small businesses——

Senator BAUCUS. Mr. Motley?

Mr. MOTLEY. One.

Senator BAUCUS. Excise taxes. Let's take alcohol and cigarettes—that category first.

Mr. OSWALD. One.

Mr. MOTLEY. One.

Mr. HUARD. One.

Dr. RAHN. With all due respect, Mr. Chairman, I am troubled by this exercise because the fundamental question we should be asking ourselves is, given any possible tax increase first of all will it reduce the deficit?

History has shown that excise taxes do not. We should also ask whether we will be better off as a people? Again, I think of my testimony and my colleagues detailed it out. You will be worse off. I guess I will say one.

Senator DASCHLE. Mr. Chairman, would you yield on that point?

Senator BAUCUS. Sure.

Senator DASCHLE. Dr. Rahn, worse off when?

Dr. RAHN. In the future.

Senator DASCHLE. Worse off than what?

Dr. RAHN. Than right now. What is the goal of economic policy? In my view, it is to maximize the growth and the real income of all of our citizens as rapidly as possible.

Now, how can we best do that? Can we best do that by increasing taxes? The empirical evidence is unambiguous and overwhelming—the answer is no. Clearly, no.

Senator **Daschle**. But that is looking at it in a vacuum, and I think you can understand that. There are other purposes in policy which also include the need to pay for the services that the American people have demanded of this country.

We have not paid for those services. We have demanded them and have not paid for them and have fallen short this year by some $155 billion.

Now, you ask: Which is worse? The deficit that we have with all its encumberances, or the revenue that we are being asked to raise? And we have to face that as policymakers.

We would like nothing more than to find ways in which to reduce revenue. We have attempted to do that in a myriad of ways; but falling short of that, we are still faced with the very bleak prospect this year of even falling short of Gramm-Rudman by some $20 billion.

So, what happens then? The prospect of passing this debt on to the next generation is becoming more and more clear, and that kind of policy is to me a bankrupt policy; and that seems to be what you are advocating.

Dr. **Rahn**. And also, the bankrupt policy is what the Congress does. You just passed a supplemental appropriation—just one example—and I read that it included the Weed Control Center.

Now, to argue that that is needed more——

Senator **Daschle**. You are citing an exception to the rule.

Dr. **Rahn**. No, no. I have listed, and we have enumerated time after time after time waste in Government programs.

What you are advocating is an increase in taxes which we know will hurt the American people where we could reduce many of these wasteful expenditures which would benefit the American people.

And you want us to come up here and say: No, go ahead and increases taxes. I am sorry, sir. I think that is irresponsible, and I will not do it.

Senator **Daschle**. It is equally as irresponsible, it seems to me, to come up and say: Look, we don't want to have anything to do with these taxes, but we demand the services.

And the Chamber, like everyone else, has demanded services. Now, the weed control project may not be the service you have demanded, but you have demanded defense. You have demanded the broad range of things the Government provides.

To my knowledge, you haven't come out in opposition to the President's budgetary proposals, which in themselves have advocated a deficit the size of which we have today.

So, I don't think it is fair for the Chamber of anybody else to be washing their hands of culpability in this regard.

We are all in this together. I apologize to the chairman for taking so much time, but I can't let something like that go.

Dr. **Rahn**. Every year at the time of the Budget Committee hearings, we have come up with a series of proposals to get expenditures under control, to get us toward a balanced budget.

We have been very specific over time on how to do that in a responsible way.

Senator BAUCUS. Dr. Rahn, on that point, though, I have before me a statistical abstract; and this is a comparative analysis of tax revenues of developed countries as a percent of GNP. This includes all taxes—State and local, including Social Security—for all countries.

This list has about 20 countries. It is 1984, the last year for which there are statistics and before the later implementation of the big tax cut this country enacted in 1981.

But in 1984, according to this statistical abstract, the United States total tax revenues as a result of GNP is 29 percent. It is the lowest of all developed countries.

There is no country with a higher tax incidence, total—State, local, and national, including Social Security—than the United States.

Let me list the countries on this list. They are Australia, Austria, Belgium, Canada, Denmark, Finland, France, The Republic of Germany, Greece, Italy, Japan, The Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

If this is accurate that would at least indicate to some degree that, in addition to further spending cuts to get the deficit down, this country can also stand to raise some revenue to get our deficit reduced.

And the fact of the matter is that, economist after economist, including Paul Volcker—I don't want to put words in Paul Volcker's mouth—but he has told me and told many others that we have to get that deficit down.

And in a macro sense to the country as a whole, it doesn't make a whit of difference—or much of a difference—whether that is in spending cuts or revenue raised or some combination, and ideally more 50/50 in revenues and spending cuts.

But from the macroeconomic sense, the primary goal and duty of this country is to do what it takes to get that Federal budget deficit reduced.

So, it seems to me that, in view of all that, all Americans helping each other out, working together, and worrying a little less about what the other guy is getting as opposed to me and more about us opposed to me and more about how we are going to compete with those other countries as Americans together in the future, are probably going to have to have some spending cuts and some revenue raised if we are going to get the deficit reduced.

Dr. RAHN. I think it is interesting that that list of countries you read off because if you look, you will also find there is virtually no job creation over the last 20 years in those countries. Over the last six years, I am sure, the total new jobs in those countries would be less than a million, where we have created about 13 million jobs, with roughly equal populations as some of those countries.

Our real rates of economic growth have been considerably higher than that group of countries you listed, and I would dispute the goal of economic policy ought to be to reduce the deficit.

I want a lower deficit, but the goal of economic policy, I say again, is to maximize the growth rate in real incomes and opportunity for all of our citizens as rapidly as possible.

And if we go this way on the European stagnation route, with high taxes and high levels of Government spending, we will not have the job creation; we will not have the growth in real incomes; and I don't think that is where most Americans want to head.

Mr. OSWALD. Mr. Chairman, could I comment on that? I think the policy that has led to the growth in the last few years has been the deficit, but it comes from mortgaging our future. As the United States has run very large deficits, we have run very large changes in programs that have borrowed from the future.

And yes, we have jobs that have been borrowed from the future; but I think in terms of where the responsibility is, in terms of spending, Congress has acted.

It has passed a budget that calls for spending cuts, and it does call for revenue raising.

I think we face the same question that Mr. North faced when he looked at the question of should he be doing what Congress and the law allowed.

And the Congress has acted on the budget, and I think that the responsibility now is to raise the revenue that Congress in its budget, adopted by both the House and the Senate, requires to be done.

I don't think people like to pay more taxes, but we can't continue to put off the burden on others, to borrow and spend more so that we have more growth now that would cause lower growth in the future.

I think that we do need to address the problem. Congress looked at it in a concurrent budget resolution, and I think the problem now is how can you equitably raise the $19 billion that the budget resolution calls for.

Senator BAUCUS. I take it then that the President is faced with the choice of either accepting further revenue in order to pay for his defense budget, on the one hand, or letting the Gramm-Rudman trigger go into effect, on the other, that you would strongly advise him to take the latter choice because that would be lower taxes and lower spending?

Dr. RAHN. Given that dilemma, I would simply go with the latter choice. Yes.

Senator BAUCUS. Thank you. We are now joined by our distinguished chairman and the distinguished Senator from New York. Mr. Chairman, it is my honor now to turn the hearing over to you.

The CHAIRMAN. Thank you very much. I apologize for not being here at the beginning of the hearings, but I have been on the floor of the Senate; and that is a problem we have here, of course. We have a trade bill going on at the same time that we are looking into the question of raising revenues.

Apparently, you have had a very interesting debate, and I am sorry I missed out on it; I am sure I will be filled in on it; but having walked into this particular hearing late and not having had the benefit of your comments, gentlemen, I will not ask any questions at this point.

Senator BAUCUS. Senator Moynihan.

Senator **Moynihan**. Mr. Chairman, I recognize the voice of prudence when I hear it, and I would like to take the same view that the chairman has. [Laughter.]

Senator **Baucus**. Senator Daschle.

Senator **Daschle**. Following my leadership, I will do the same. I would enjoy more of this debate, but I do appreciate the need to be at two places at once today—both on the floor with the trade bill and in the hearings today with regard to revenue.

I might just ask one question and limit myself to that.

Due to the dilemma we face between the deficits we have and the prospect of raising revenue, which is now upon us, of the options that the temporary chairman was proposing today—excise taxes, changes in income tax, consumption taxes—I would like a succinct as possible a response to the question as to which of those is most desirable, recognizing that none of them may be acceptable or palatable.

But if you were going to put them in some rank order, given the Federal propensity to limit taxes beyond income—especially with regard to individuals to taxes outside the area of consumption in large measure—would you favor consumption related taxes more than you would favor excise taxes or other forms?

Let's start with Mr. Motley.

Mr. **Motley**. I thought I was going to get a chance not to answer that question.

Senator **Daschle**. The question is not "none of the above" because we don't have that answer.

Mr. **Motley**. The least objectionable type of tax from the polling that we have done from our membership are excise taxes. Still, though, they tell us that they would not be in favor of raising taxes.

I think they share the view that Senator Baucus expressed that the deficit is the number one long-range broad problem facing the country, and we have supported revenue in the past as a way to bring down that deficit and would not be opposed to some revenue.

But I think that the membership is somewhat concerned that what revenue we have supported in the past has not gone to reduce the deficit, but has gone to new spending; and they don't have a great deal of confidence that any new revenues that would be raised would go to reduce the deficit.

But of the choices that you put forward, the most acceptable or least objectionable would be an increase in excise taxes. The most objectionable would be an increase in corporate and personal income tax rates.

Senator **Daschle**. All right. Mr. Oswald.

Mr. Oswald. The belief is that taxation should be based on ability to pay. The only way that one can find a tax system that does make distinctions based upon people's ability to share the burdens of government is to have an income tax.

And therefore, we would support a progressive change in the income tax; selective excise taxes would be second in that choice only because it would be on certain products versus others, but certainly would not be progressive because it clearly has an unfair impact on people, whether that be gasoline or cigarettes or whatever.

And some of those may be very related to income production—gasoline in terms of driving to and from work or taking products to and from the farm, etcetera.

And the most objectionable, in general, would be the general consumption tax because that would be the most regressive of any.

Senator DASCHLE. Thank you. Dr. Rahn.

Dr. RAHN. Clearly, theoretically, the taxes on capital—given the size of the deficit—would be far more destructive than taxes on consumption.

And if Congress is really going to bring down spending and alter our tax system, that would be the way to go; but I would still like to argue that I have given you options of more than $20 billion of revenue raisers under the jurisdiction of this committee which I think would be far less destructive than those alternatives.

Senator DASCHLE. Mr. Huard.

Mr. HUARD. As I think I indicated in my testimony, we would certainly object strenuously to any further increase in income taxation on the grounds that income is already taxed excessively in this country.

We think if there is to be an increase in taxation, it should be imposed on consumption. We believe that selective consumption taxes, namely the excise taxes, are inherently unfair and distortionary. They are undeniably regressive; and the problem is that you cannot correct for that regressivity.

We therefore believe that the least counterproductive tax revenue increase would be a general consumption tax imposed at a uniform rate on the broadest possible base of goods and services.

Such a tax would be neutral, rather than distortionary, and it can readily be corrected for regressivity.

Senator DASCHLE. Thank you and thank you, Mr. Chairman.

Senator BAUCUS. Mr. Chairman.

The CHAIRMAN. Mr. Motley, I was noticing in the Joint Tax Committee's list of options for revenue raisers an old item that has been fought over many times in the past.

I understand you touched on the question of estate taxes, and that is the thought of carryover basis, meaning to revive the possibility of a double tax on debt.

We have no capital gains tax now. So, in effect, you are talking about an income tax, and that would mean an income tax on debt for income that had not been accrued.

And in addition to that, a death tax. So, you could have a tax that would be 55 percent—I guess that is the top margin on estate taxes—and then you could have an income tax of 28 or 38 percent. And frankly, I don't think death is a voluntary conversion, when it comes to estate taxes. [Laughter.]

What would be the reaction of your association and its membership if you had a restoration of the idea of a double tax on death?

Mr. MOTLEY. Mr. Chairman, we would oppose such a double tax on death very bitterly and very vigorously.

The CHAIRMAN. Why?

Mr. MOTLEY. Because it is an extremely emotional issue with our members. All you have to do really is take a look at what happened in the 1980 White House Conference on Small Business under President Carter and then the 1986 White House Conference on Small Business under President Reagan.

These are issues that sort of bubbled up; and when business people get together and they start talking about the ability to continue their business, the ability to pass on their sweat/equity over the years or their risk-taking over the years, and then they realize that that possibly could be wiped out because the business would have to be placed on the blocks in order to pay off the taxes and generally at bargain basement rates and liquidate it—jobs, everything gone.

They get extremely emotional about it. It is not an issue that they talk about day in and day out like income taxes or even excise taxes; but when the subject is brought up, it is one which I think gets them highly motivated and makes them speak out.

So, I would think that as soon as it appeared that the Congress was ready to move in that direction, we would have an outpouring of complaint, not only from small business owners across the country but also from farmers, whom we represent a considerable number of.

The CHAIRMAN. I recall one of the other problems when we were on that issue before. We heard that from trust departments, and we heard it from people who were having to administer estates.

One of the problems was trying to figure out what the cost basis was because the people who knew were dead. And sometimes generations of deaths have taken place as a piece of property or a family business was held together.

And so, you run into a very difficult problem of administration, in addition to the fact that you would pay a double tax, and you would pay far beyond the estate tax.

Mr. MOTLEY. You also have to pay for the expertise to help you keep all those records straight and to prepare your family for the day when that situation may arise.

That is an indirect tax upon the operating business or the operating farm, and in most cases, the answer to that is taking out rather healthy insurance policies to pay the tax, which is a reduction in the capital available to that business at that time.

So, small business people will point this out generally that the biggest boon that happened in 1981 in terms of the reforms made in estate taxes is they no longer had to spend huge amounts of money purchasing life insurance policies to take care of their businesses after death.

The CHAIRMAN. Thank you very much.

Senator BAUCUS. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I would like to ask our eminent panelists one question about a subject that will be coming up on the next panel.

We, as a committee, invited the Joint Committee on Taxation and its very distinguished staff to suggest ways in which we might raise revenue. One of the more ominous proposals—or at least one of the more conspicuous ones—is the proposed excise tax on net investment income of exempt organizations.

This is a tax which would most conspicuously fall on private colleges and universities and private hospitals—charitable activities of that kind—but it would also fall on trade unions. It would also fall on trade associations.

It would fall on union pension plans, and similar plans that the Chamber and other like organizations have set up for themselves.

Could I ask specifically the labor unions and trade associations about the trusts forming a part of a qualified pension or profit-sharing plan? This proposal would apply to many of your constituent members as well as your own organization—the proposal to impose an excise tax of 5 percent on net investment income from tax exempt organizations.

Could I just ask your opinions, seriatim, as we say? Dr. Rahn, I think you testified first, sir?

Dr. RAHN. We would be opposed to that. Normally, the tax exemption was given for a particular purpose. You people decided that you wanted to encourage certain types of activities; and then to go ahead and penalize people for engaging in those activities—such as colleges, universities, labor unions, what have you—seems to me to be somewhat counterproductive.

And I know among our members particularly there is a very strong reaction against it.

Senator MOYNIHAN. A very strong reaction? All right. Mr. Oswald.

Mr. OSWALD. Senator, the labor unions would also be greatly upset with such a tax because again it would tax the sort of people who have already paid tax on their income, and an additional tax seems unwarranted on a tax exempt organization.

Senator MOYNIHAN. Yes. Dr. Rahn's point was that we would not have allowed these to be exempt if we had not wanted to encourage such activities. Mr. Motley.

Mr. MOTLEY. We would be opposed at this time, Senator; and we think that it really should be considered only if the committee gets into examining the tax status of the entire nonprofit community as a whole, such as the Ways and Means Committee is doing over on the House side.

Senator MOYNIHAN. And Mr. Huard.

Mr. HUARD. We would be opposed, Senator. I think that it is counterproductive to go through a process of granting an exemption to an organization and then saying, well, it is a 95-percent exemption.

You could be just as well served and probably raise a great deal more revenue if you inquired into making tax exempt general obligation bonds of States and municipalities 95 percent tax exempt, instead of 100 percent tax exempt.

Senator MOYNIHAN. Don't say that in front of the committee. We have got to be careful. [Laughter.]

Mr. Chairman, I thank you for the opportunity to ask this question. We have some persons before us from a very real world of economic activity who will take a position, I think, which will be mirrored by persons from the somewhat more distant world of teaching and research and caring for the ill.

And I think we will find a common view on this subject, which is always welcome in this committee. Thank you, gentlemen.

Sentor BAUCUS. Thank you, Senator. Any other questions?

[No response.]

Sentor BAUCUS. Thank you all very much for your very valuable testimony. Thank you.

The CHAIRMAN. Let me be sure that we have all the members of the next panel. We have Bishop Steward, Mr. O'Connell, Mr. O'Neill, Mr. Bloomfield, and Dr. Minarik.

Let me go through the affiliations of those who are speaking on this panel. Bishop Stewart represents the Episcopal Church Pension Fund, and he is testifying on behalf of The Church Alliance.

Mr. Brian O'Connell is President of the Independent Sector. Mr. Robert O'Neill is President of the University of Virginia and is testifying on behalf of the American Council on Education.

Mr. Mark Bloomfield is the President of the American Council for Capital Formation. Dr. Joseph J. Minarik is a Senior Research Associate of The Urban Institute.

Gentlemen, we are pleased to have you. Dr. Stewart, we would be pleased to have you lead off. I think that would strike the proper attitude for this particular panel.

## BISHOP ALEXANDER D. STEWARD, EPISCOPAL CHURCH PENSION FUND, TESTIFYING ON BEHALF OF THE CHURCH ALLIANCE, NEW YORK, NY

Bishop STEWART. Our abiding appreciation, Senator Bentsen, to you and your colleagues for your courtesy in allowing me to share with you.

I would like our testimony to be submitted for the record. I shall be brief, recalling that verse of scripture: I have many things to say unto you, but you cannot bear to hear them now. [Laughter.]

What a privilege to represent such a responsible group as Church Alliance, which acts on behalf of 28 church pension programs. Aware we are of your need to uncover sources of untapped revenue.

If added taxes are required, we should all pay our fair share, but do not ask retired clergy and their widows to accept a reduction in pension which would be inevitable if you were to endorse the proposal that would place a 5 percent tax on the investment income of tax exempt religious institutions.

Since well over one-half of our budget for retirees is derived from investments, we would be forced to reduce the minimal pensions on which a retired couple has already based their budget.

Such tax investment income is the prime resource for funds required to carry out this mission of our synagogues and churches.

Whether taxing investments of a church pension plan can be declared unconstitutional, since it may violate the separation of church and State, must be recognized as a valid question.

This is a very sensitive area, as every legislator and teacher is aware. You can decide, however, is it fair to take from the elderly?

Might not a more appropriate source of revenue be found,

You might even ask: Is it fair to tax exempt groups to take 5 percent of their investment income when corporation and financial houses can, by creative accounting, escape or indefinitely delay taxes on their investment income?

Finally, a recent study indicates that two-thirds of the time, energy, and dollars expended in the volunteer sector of our country in social agencies and services is generated by the religious community.

If legislation is enacted which reduces money for pensions by 5 percent, we will not break our promise to retired people to whom we have promised pensions and health care. We will make up the difference by depleting other budgets, the very budgets that maintain the buildings and personnel that guide and provide for our volunteer services.

Churches throughout our country today have responded and are feeding meals to the needy, providing sleeping facilities for the homeless, day care for mothers who prefer working to welfare, and a gathering place for elderly.

How can church leaders decide: Is this money to go to pensioners to make up the difference caused by the 5 percent tax, or do we give it to the self-help programs undertaken at the suggestion of our President?

Since we cannot spend the same dollar twice, if we must give it to the tax bureau, it will not be available for elderly and disabled persons or for the caring ministry that synagogues and churches have undertaken.

Frankly, I would not wish to be the messenger of bad news, informing retired clergy that the pension fund cannot fulfill its promise and their next pension fund check will be reduced. Would you?

And would you at least ask: Is this proposal wise? Is it fair? And is it really necessary?

Thank you.

Senator MOYNIHAN. Thank you, Bishop. Brian O'Connell, we welcome you back to this committee.

[The prepared statement of Bishop Stewart follows:]

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Dr. Ray Vander Weele
Christian Reformed Church in North America

Dr. Jewett L. Walker
A.M.E. Zion Church

Dr. L. Edwin Wang
Lutheran Church in America

Dr. Dean Wessels
Church of the Nazarene

Dr. Dean R. Wright
American Baptist Churches

## STATEMENT OF THE RIGHT REVEREND ALEXANDER D. STEWART, D.D.

I am The Right Reverend Alexander D. Stewart, D.D., formerly Executive for Administration of the Episcopal Church and now serving as Senior Vice President (Pastoral Care) of The Church Pension Fund. The Fund was chartered by an Act of New York state legislature in 1914 for the purpose of establishing and administering a retirement pension system for aged and disabled priests of the Episcopal Church. It is recognized by the Treasury Department as a tax-exempt religious organization. We are one of the founding members of the Church Alliance, a coalition which acts on behalf of the pension programs of the 28 religious denominations identified on the Church Alliance letterhead. My appearance here is on behalf of these organizations.

My comments deal with one of the "possible options" for increasing tax revenues in connection with the fiscal year 1988 Budget Resolution now being considered by the Senate Finance Committee. This option, No. II. F. 2. in JCS-17-87, would impose a 5 percent excise tax on the net investment income of tax-exempt organizations, a tax that would impact churches and their ministry organizations, including church pension boards.

This revenue option would diminish the ability of church plans to fulfill contractual commitments already made to pay the pensions earned by clergy and layworkers.

Before the Committee considers imposing an excise tax on the net investment income of tax-exempt organizations, including churches, synagogues, and their pension plans, it should consider the following:

(1) Generally, TAX-EXEMPT organizations operate without a profit motive, make no profits, and, therefore, would pay no tax on their investment income if they were subject to income taxes. However, under this excise tax option, a tax would be payable even if the organization operated at a net loss on its activities. On the other hand, the excise tax option under consideration would not impose a tax on a for-profit business organization with identical investment income under identical circumstances, i.e., no net profit for the year.

(2) Many TAXABLE organizations are not now paying income taxes on all of their net investment income. For example:

* Regulated investment companies and real estate investment trusts pay no income tax providing they distribute all investment income to their shareholders; banks, insurance companies, and financial institutions pay no income tax on investment income derived from investments in municipal bonds.

* Corporations pay taxes on only 20 percent of investment income derived from dividends received from holdings of stock and pay no income tax for years in which they report no net income.

* Depreciation, depletion, percentage-of-completion and other permissible tax accounting techniques enable many companies to eliminate or continually defer taxable income, thus offsetting investment income which otherwise would be regarded as net taxable income.

Retirement and welfare benefits for ministers and layworkers are mainly provided through church pension boards. Church pension boards are controlled by or associated with a church, either as divisions of the church denomination or as separately organized section 501(c)(3) entities. A number of pension boards provide retirement benefits in the form of retirement income accounts under section 403(b)(9) of the Code. Some pension boards provide retirement benefits through plans described in section 401(a) of the Code.

A church pension board is an integral part of the church, carrying out the functions of the church in providing retirement and welfare benefits for clergy and other denominational employees. Thus, any excise tax that may be levied on the net investment income of a church pension board would be a tax on the church. There are Constitutional implications of taxing the income of a church. The First Amendment to the Constitution states in part, "Congress shall make no law respecting an establishment of religion ...." This, the Establishment Clause, in the words of Thomas Jefferson, "was intended to erect 'a wall of separation between church and state.'" Everson v. Board of Education, 330 U.S. 1 (1947). The Supreme Court in Lemon v. Kurtzman, 403 U.S. 602 (1971), set forth three tests a statute must pass in order to avoid the prohibition of the Establishment Clause. The third test is that the statute must not foster "an excessive governmental entanglement with religion." An excise tax on a church necessarily raises the question of governmental entanglement with religion. This is a very sensitive area. It would involve the filing of forms with the Internal Revenue Service, the possible subjection of books and records to examination, and other acts which may produce direct confrontations with religion and intensive surveillance of religion which would not be constitutionally acceptable. Tilton v. Richardson, 403 U.S. 672 (1971).

The excise tax would also be extremely unfair to church pension boards and the participants and beneficiaries of church plans. For many years, church pension boards have made monetary commitments to church employees with respect to a level of retirement benefits. These committed benefits have been based on contributions received, mortality experience, and earnings assumptions; there were no additional assumptions such as the payment of a 5 percent excise tax on net investment income proposed for consideration by your Committee. The payment of a tax on net investment income used to pay retirement annuity benefits would create a hardship on church pension boards and possibly reduce retirement benefits to plan participants and their beneficiaries. Nevertheless, if this excise tax is enacted, it would be necessary to have statutory authority permitting the tax to be passed through to plan participants and their beneficiaries as if applied directly to them. Otherwise, what is referred to as an excise tax on net investment income becomes, in fact, a tax on the corpus of the church or church pension board itself, to the extent the church has committed to pay a fixed annuity benefit based on a stated return on investment (prior to any taxes).

As noted above, some church pension boards provide benefits in the form of section 403(b)(9) retirement income accounts while others provide benefits through plans described in section 401(a). If the Congress decides to exempt the net investment income of section 401(a) qualified plans from the excise tax, a similar exemption should be accorded to section 501(c)(3) church pension boards that provide retirement benefits to ministers and lay workers. Otherwise, an unfortunate disparity of treatment of church pension plans and boards will result.

As a final thought on the excise tax, I would again point out that generally charitable organizations operate without a profit motive, and many operate at a loss. Yet this tax, which is like a gross income tax, does not distinguish between the ability to pay or the inability to pay. Indeed, whether or not operating at a loss, some charitable organizations with net investment income may have difficulty raising the tax except through the sale of principal assets. The definition of net investment income is critical in this context.

In conclusion, of overriding importance to the churches is the fact that if this is imposed on churches and their pension boards, the resources of every church would be diverted from its mission. Some have said that the mission of a church can be perceived as divisible into

(1) worship of God and

(2) service of mankind.

The Congress would undoubtedly find it constitutionally impossible to interfere with the former and counter-productive to interfere with the latter. The Pamphlet No. JCS-17-87 clearly points out on page 276 that the exemption from tax under existing law recognizes that:

(a) "...Many exempt organizations perform functions that lessen the burdens of government that otherwise would have to be financed out of tax revenues...", that

(b) tax-exempt organizations "...promote the general welfare of the public at large..." and

(c) "...contribute to the economic well-being of the country through promotion of business and labor;" and specifically notes that

(d) "The imposition of the tax would reduce the funds available to and needed by charities, social welfare organizations, and other exempt organizations in carrying out their nonprofit activities. The tax thus would adversely affect the beneficiaries of these programs, including the poor, the elderly, students, hospital patients, the environment...."

We believe it is of utmost importance that this Committee inform itself of the extent, if any, to which these negative economic factors in (a), (b), (c), and (d) are reflected in the "Estimated Revenue Effects" appearing in the pertinent sections of the document now under consideration.

Respectfully submitted,

The Right Reverend
Alexander D. Stewart, D.D.

July 17, 1987

## STATEMENT OF BRIAN O'CONNELL, PRESIDENT, INDEPENDENT SECTOR, WASHINGTON, DC

Mr. O'CONNELL. Thank you. As you so well know, nonprofit organizations have been through three major crises in the past six years. The first involved the budget cuts which have had an enormous impact on nonprofit organizations. The second involves the transfer or the expected increase in the service loads of nonprofit organizations.

As Government has cut back, it has transferred to voluntary organizations services for day care, services for homeless, for the aged, educational responsibilities. So, we have had less money and a transfer of responsibilities.

In terms of that less money and transfer, the Urban Institute recently completed a study which pointed out that, for the primary service areas where there is a public/private partnership in the delivery of education or human services, financial support was reduced by the Federal Government by $70 billion, or 14 percent, over the fiscal years 1982 to 1986.

The second impact indicated by the Urban Institute report is that reduction in direct Federal support of the programs of nonprofit organizations for those same years was $23 billion, or 27 percent.

And third, they point out that for private giving to make up for the Government's reductions in the areas where we attempt to deliver services mandated by Government, private giving to make up for that would have to increase by six to eight times higher than the peak increases of the past few years.

The third major crisis involved the Tax Reform Act and its impact on attempts to gain increased giving. The combination of reduced rates, the loss of the nonitemizer deduction, and the inclusion of gifts of appreciated property in the calculations of income under the alternate minimum tax will, in the combination—according to Professor Lawrence Lindsey of Harvard and the National Bureau of Economic Research—cause an impact on annual giving of approximately $11 billion, or 15 percent.

Throughout the tax reform process, we said over and over again, in response to your understandable admonition that we all had to share the burden, we said that we have been inordinately impacted. If you take the combination of the budget impacts and now the tax impacts on voluntary organizations, it is not equitable.

It is certainly not unfair. It is grossly unfair for the Government to transfer some of its service load, then cut its share of the partnership, and then on top of that to make raising contributed funds even more difficult.

Now, on top of all that, unbelievably—as far as we are concerned—unbelievably along comes this Joint Committee report that serves up the idea of a new excise tax on our organizations.

It says that this new tax will increase income by $3.5 billion in 1988, of which $1 billion will come out of the capacity of voluntary organizations and foundations to be of service.

On top of that $1 billion loss, the Joint Committee offers that the itemized deductions might be allowed only against the 15-percent tax rate, and that alone would decrease contributions by another $6 billion annually.

Beyond even the arithmetic and the inequity of the moment, this excise tax is contrary—contrary—to the underlying concept of tax free organizations.

In 1969, Congress imposed a 4 percent tax on foundations; but only under the rationale and with the absolute assurance—that the absolute assurance—that that 4 percent tax would be used only to monitor the work of foundations. That tax was reduced in 1979 to 2 percent; but it still produces $217 million a year, which is six times the total budget of the exempt division of IRS.

I submit that the tax on tax exempt organizations is fundamentally a contradiction. I submit that it is a classic oxymoron.

There are several other provisions in the Joint Committee's document, such as an increase in the alternate minimum tax from the present 21 percent to 25 percent, initiation of a 10-percent floor on aggregate itemized deductions for certain taxpayers, and an across-the-board reduction in individual tax preferences, which would have a negative effect on the income of nonprofit organizations.

These reductions and the others mentioned above total $9 billion. We implore you, we beg you to establish at the outset of your considerations a principle and a determination not to do anything further to reduce the capacity of voluntary groups to fulfill our public service.

You asked us to take a larger share of public services. You have dealt us an inordinate share of the burden of tax reform. We believe it is fair to say that enough is enough.

The CHAIRMAN. Thank you very much, Mr. O'Connell. Those are some very interesting numbers. I will be looking forward to perusing those.

Mr. O'Neill, Professor O'Neill, Dr. O'Neill.

Mr. O'NEILL. Senator, any of the above.

The CHAIRMAN. Whatever title you prefer, we are delighted to have you here with us this morning.

[The prepared statement of Mr. O'Connell follows:]

## TESTIMONY OF BRIAN O'CONNELL
## PRESIDENT, INDEPENDENT SECTOR

I am Brian O'Connell, President of INDEPENDENT SECTOR, a membership organization of 654 national voluntary associations, foundations, and corporate giving programs. A list of our members is attached.

During the past six years nonprofit organizations have faced three major crises:

1. Reductions in federal spending, particularly for human services, caused the caseloads and expectations for services of voluntary organizations to increase crushingly.
2. At the very time the government was transferring to nonprofits greater responsibility for services, the same government reduced dramatically its financial support for such services. According to the Urban Institute report, The Nonprofit Sector and the Federal Budget:
   a. For the primary service areas where there has been a traditional public/private partnership, financial support was reduced by $70 billion* or 14 percent for the fiscal years 1982-86.
   b. Reduction in direct federal support of the services of voluntary organizations for those same years was $23 billion or 27 percent.

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* Exclusive of Medicare and Medicaid funding.

   c. For private giving to make up for the government's reductions would have required giving to grow at a rate seven to eight times higher than the peak rate achieved in recent years.

3. The Tax Reform Act of 1986 made raising contributed funds more difficult. The combination of reduced rates, the elimination of the charitable deduction for nonitemizers, and the inclusion of gifts of appreciated property in the definition of income for the alternate minimum tax will, according to Professor Lawrence Lindsey of Harvard and the National Bureau of Economic Research, cause an impact on annual giving of approximately $11 billion or 15 percent. To try to offset some of this loss, INDEPENDENT SECTOR has just launched an initial five-year effort to try to increase the total amount that individuals contribute to the causes of their choice.

Throughout the tax reform process, we were told that everyone had to share the burden, but we have been trying to point out that the combination of budget and tax impacts on voluntary organizations is not equitable. It is certainly not fair for the government to transfer some of its service load to us, then cut its share of the partnership and, on top of it all, to undermine our ability to raise money.

Now, almost unbelievably, along comes a Joint Committee report that serves up the idea of a new excise tax on exempt organizations which it says could raise $3.5 billion in 1988, of which at least $1 billion would come out of the program and granting capacity of voluntary organizations and foundations. On top of that $1 billion loss, the Joint Committee offers that itemized deductions might be allowed only against the 15 percent tax rate. This proposal alone would reduce charitable giving by another $6.7 billion annually according to research by Professor Lindsey.

For the Federal Government to consider slashing another $8 billion or 10 percent, or any substantial proportion thereof from the income of the sector to which it is transferring so much of the service burden is absurd in concept and cruel in execution.

Beyond all of that, this excise tax is contrary to the underlying concept of tax-free organizations. In 1969, Congress imposed a four percent excise tax on foundations under the rationale and assurances that the income would be used only to monitor the work of foundations. That tax was reduced in 1979 to two percent but still produces $217 million a year (1986) which is six times the total budget of the entire exempt division of IRS. To begin to tax tax-exempt public charities and the foundations that help support them is fundamentally a contradiction.

There are several other provisions in the Joint Committee's document, such as an increase in the alternative minimum tax from the present 21 percent to 25 percent, initiation of a 10 percent floor on aggregate itemized deductions for certain taxpayers, and an across-the-board reduction in individual tax preferences, which would have a negative effect on the income of nonprofit organizations. These reductions and the others mentioned above, total $8.687 billion, as follows:

| | | |
|---|---|---|
| 5% excise tax | $-1.0 billion | |
| Allow itemized deductions only at 15% rate | -6.7 billion | |
| 25% alternative minimum tax | | $-221 million |
| 10% floor | | -346 million |
| Added preferences | | - 42 million |
| Total | $-8.687 billion | |

We implore you to establish at the outset a principle and a determination not to do anything further to reduce the capacity of voluntary groups to fulfill their public service. The government asked us to take a larger share of human services and then you dealt us an inordinate share of the burden of tax reform. It is fair to conclude, enough is enough.

## STATEMENT OF ROBERT O'NEILL, PRESIDENT, UNIVERSITY OF VIRGINIA, TESTIFYING ON BEHALF OF THE AMERICAN COUNCIL ON EDUCATION, CHARLOTTESVILLE, VA

Mr. O'NEILL. I am delighted to be here. I am here this morning on behalf of the American Council on Education and about a dozen other higher education groups whose names appear on the cover sheet of the statement that we have filed.

I cannot claim to be expert on matters of tax policy, but I do have some feeling for the special role of nonprofit organizations.

Before I came to Virginia, I was for five and a half years President of the University of Wisconsin. I have served and now serve on the boards of various organizations such as the Carnegie Foundation for the Advancement of Teaching, the Educational Testing Service, the Johnson Foundation, the Association of American Colleges, the National Association of State Universities and Land Grant Colleges, among others.

Each of these organizations, like the colleges and universities that comprise ACE, has a deep concern with the proposals that are now before this committee.

Several of these proposals, we think, might have harmful effects on higher education, but there is one that we feel would have an especially serious impact. It is the proposed five percent excise tax on the net investment income of tax exempt organizations.

Let me, if I may, make three points of particular concern to us in the college and university world.

First, nonprofit organizations and institutions like ours differ from the profit sector in that we lack comparable ways of sharing or redistributing or passing on the effects of reduced revenue.

The only recourse for most of us would be to reduce educational services or increase tuition or some combination of the two.

That choice would come at a time when Government has been asking higher education to assume greater responsibility while reducing the resources available to meet that task.

The dilemma is especially clear in the area of financial aid. Private colleges and universities have found it necessary to increase the scholarships they provide to their students from $900 million, as recently as 1981/1982, to $3 billion in the last academic year.

Second, the tax would fall directly on endowments, which are important and unique features of educational institutions.

These are sources of support which Government has over the years encouraged in many ways and which have helped to offset, for a State government, the cost of public higher education.

We in Virginia, for example, enjoy an especially wise State policy in the Eminent Scholars Program, a program under which the Commonwealth matches income, dollar for dollar, from private endowments mainly for faculty and chairs.

This program represents one of the many joint public/private efforts in support of the university's commitment to academic excellence.

During the past year, more than 180 members of our faculty received substantial salary support from endowment income and the matching State support under this program.

To tax endowment income and net capital gains would not only reduce income and impair endowment principal, but also in effect would reduce the State support that matches the private endowment income component.

Third, this tax, as we see it, would mark a fundamental change in national policy. A change that would far exceed what the rather modest percentage or the tax might suggest.

Such a tax would basically alter the relationship enjoyed by tax exempt institutions. It would replace that status with an income tax measured by the amount of investment income.

For those universities that have been most energetic and most successful in seeking private support, such a change in policy would in effect impose a penalty after the fact.

For other institutions that have investment income that is used to offset operating losses, the proposal could result in a larger tax liability than would the application of the corporate income tax.

Such a tax also seems to us to undermine the Congressional policy of encouraging economic development through wise and selective use of university resources.

Finally, I would note that the issue is not whether we are willing to do our part or pay our share. The issue that has now been raised, and really raised for the first time, is whether all investment income of such institutions—most of which in our cases goes to uniquely educational programs—ought to be subjected to tax.

Such a proposal seems to us to strike at the central premise of the tax exempt status of institutions such as ours, a status which has long been of benefit to our students and those whom we serve in other ways and, ultimately, to the nation as a whole.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Dr. Minarik is a Senior Research Associate at The Urban Institute.

[The prepared statement of Mr. O'Neill follows:]

TESTIMONY OF

THE

AMERICAN COUNCIL ON EDUCATION

on behalf of:

AMERICAN ASSOCIATION OF COMMUNITY AND JUNIOR COLLEGES
AMERICAN ASSOCIATION OF STATE COLLEGES AND UNIVERSITIES
ASSOCIATION OF AMERICAN MEDICAL COLLEGES
ASSOCIATION OF AMERICAN UNIVERSITIES
ASSOCIATION OF JESUIT COLLEGES AND UNIVERSITIES
ASSOCIATION OF URBAN UNIVERSITIES
COUNCIL OF INDEPENDENT COLLEGES
NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS
NATIONAL ASSOCIATION FOR EQUAL OPPORTUNITY IN HIGHER EDUCATION
NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES
NATIONAL ASSOCIATION OF SCHOOLS AND COLLEGES OF THE UNITED METHODIST CHURCH
NATIONAL ASSOCIATION OF STATE UNIVERSITIES AND LAND-GRANT COLLEGES

ON THE PROPOSED

FIVE PERCENT TAX ON INVESTMENT INCOME

OF TAX-EXEMPT ORGANIZATION

Presented By

ROBERT M. O'NEIL
PRESIDENT, UNIVERSITY OF VIRGINIA

BEFORE THE

COMMITTEE ON FINANCE

U.S. SENATE

JULY 17, 1987

## I. Introduction

My name is Robert O'Neil. I am the President of the University of Virginia, a state University founded by Thomas Jefferson in 1819. I am testifying this morning on behalf of the American Council on Education, an organization representing over 1,500 colleges and universities, and the associations listed on the cover sheet of this testimony, which together represent our nation's institutions of higher education.

Although the staff pamphlet of revenue raising options contains several proposals that would adversely affect institutions of higher education, one in particular would have a particularly serious impact on colleges and universities. This is the proposed five percent "excise" tax on the net investment income of tax-exempt organizations.

We strongly oppose this provision. It would have a substantial negative impact on the ability of the vast majority of colleges and universities to perform their mission of education and research and would constitute a fundamental withdrawl of their tax exemption.

## II. Analysis of the Proposal

### A. The amount of the tax would have a substantial impact on the ability of colleges and universities to perform their mission.

The pamphlet suggests that this tax would have a "limited impact on the activities of exempt organizations." At least as applied to institutions of higher education, however, the proposed tax would have a substantial adverse impact. Virtually all institutions of higher education have investment income that provides support for their operations and, therefore, would have tax liability under this proposal.

Unlike for-profit entities, public and private colleges and universities do not have investors to whom they could reduce the distribution of profits in order to pay the proposed tax. Therefore, this tax liability would have to come from increased tuition or from reduced services to present or future students.

In recent years government has transferred greater responsibilities to higher education, while at the same time reducing the resources available to meet these responsibilities, such as tax law changes that will tend to reduce charitable contributions. One area where government has transferred greater responsibility to higher education is the increased need for institutional student financial aid in the form of grants. Private institutions of higher education have increased scholarships greatly in the last few years (from $900 million in 1981-82 to $3 billion in 1985-86).

The combined effect of the inability to reduce distributions to shareholders, the increased responsibilities of these institutions, and decreased resources as the result of recent federal tax law changes, is that the imposition of this tax would reduce directly the resources available to support their mission.

At the University of Virginia, we have estimated the amount of this tax at about $3 million per year. This is a significant amount of money to our University

- It is slightly more than the budget of our history department, $2.1 million, and approximately equal to the budget of our physics department.

- It is slightly less than the amount of our student financial aid grants, which are paid directly from our endowment income.

B. The tax would be applied to endowments, which are important and unique features of educational institutions.

Hundreds of colleges and universities, public and private, large and small, have endowments. These endowments were established solely to support the tax-exempt purposes of education and research.

In addition, the University of Virginia has an Eminent Scholars Endowment, separate from its regular endowment, the income from which is matched by the State of Virginia. The tax liability from this proposed tax would more than offset the matching state grant from this program.

Our endowments provides a stable source of funding that encourages the free expression of ideas essential to first rate scholarship and research, as well as providing funds for scholarships.

C. This tax is a fundamental change in tax policy, and is far more significant that it would appear as a relatively small percentage tax on only one part of college and university income.

This tax would effectively terminate the exemption from federal income tax for the vast majority of tax-exempt institutions that have investment income, and replace it with an income tax based on the amount of their investment income.

For financially weaker institutions, the proposed tax could result in a larger tax liability than would the application of the corporate income tax. Institutions that are financially pressed due to declining enrollments, and that are suffering consequent tuition shortfalls, but which have investment income that is being used to offset these operating losses, would have no "net income" and thus would pay no federal income tax if they were taxable corporations. They would pay tax under this proposal, however.

This tax also would be inconsistent with the concept of tax exemption. It is justified in the staff pamphlet solely on the grounds of raising revenues. It therefore is not fundamentally different from a tax on tuition or charitable contributions, which are not taxed under present law because these sources of funds, like investment income, are provided directly and solely to support the exempt purposes of these institutions.

This tax would also frustrate Congressional efforts to improve the competitiveness of our economy. Colleges and universities have developed into responsive instruments for pursuing national objectives. The tax would withdraw funds from these institutions at the same time that Congress is attempting to increase their funding for biomedical research, research related to national security, and need-based student assistance. I believe that colleges and universities can best contribute to deficit reduction by providing a sound foundation for economic growth through the creation and dissemination of new knowledge.

D. This major change in the treatment of public and private colleges and universities is not justified.

It is supported in the staff pamphlet by only one argument: that exempt organizations should "not be immune from sharing some of the costs of government." Colleges and universities already share the costs of government. The state institutions are units of government, and the private institutions are tax-exempt because they relieve government of the burdens of meeting public needs by enlisting private funds for public benefit and by performing activities that government otherwise would be called upon to perform.

This proposed tax on public institutions and public charities is not warranted by any need for additional revenues to monitor tax-exempt organizations, which was the reason for the excise tax on the investment income of private foundations. Additional audit fees for exempt organizations would not seem to be needed since the two percent tax on private foundations already generates revenues that are six times the budget of the entire exempt organization division of the IRS.

The proposed tax also is not supported by the policies underlying the unrelated business income tax (UBIT). When Congress enacted the UBIT law in 1950, it exempted investment income from the tax because it concluded that investment income did not present problems of competition with business. Last month, in testimony before the Ways and Means Oversight Subcommittee, the Treasury recommended that investment income continue to be totally tax exempt because: the income is used to support the exempt purposes of the organization; it does not present problems of unfair competition; and it encourages exempt organizations to avoid commercial involvements.

## III. Proposals to restrict charitable giving should be rejected.

In addition, the staff pamphlet restates proposals, previously considered and rejected by Congress, that would substantially reduce the benefits of our tax-exempt status by reducing the amount of charitable contributions. These changes would: 1) permit itemized deductions, including the charitable deduction, to be deducted only against the 15 percent tax bracket; 2) impose a floor on itemized deductions of 10 percnet over $100,000 in adjusted gross income; and 3) reduce the value of all deductions by 10 percent.

Congress should again reject these changes in the tax law that would discourage charitable giving and thus reduce the ability of higher education to perform its important mission.

## IV. Conclusion

The higher education community strongly urges the Committee to reject this proposal. It is unsound tax policy in that it would effectively terminate the tax exemption for institutions that warrant continued tax-exempt treatment. It is unsound education policy in that it would take funds away from colleges and universities that are used for scholarships and that in magnitude are equal to the cost of major departments. It is unsound economic policy in that it would impair our ability to perform the research activities necessary to improve our competitiveness in world markets.

I thank the Committee for its consideration of our views on this issue of utmost importance to our institutions of higher education.

## STATEMENT OF DR. JOSEPH J. MINARIK, PH.D., SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE, WASHINGTON, DC

Dr. **MINARIK.** Mr. Chairman, let me first of all put on the record that I am here speaking for myself and not my organization.

I am here to speak about the proposal in the——

The **CHAIRMAN.** Now, that comes as a bit of a surprise to me. We have chosen people to speak for a broad-based constituency, but please proceed, Dr. Minarik.

Dr. **MINARIK.** I am here to speak to the proposal that is in the aforementioned Joint Committee publication with respect to reducing the maximum tax rate on capital gains.

In my own point of view, I believe that that proposal is misplaced. It is not a revenue-raising proposal; and, therefore, it does not belong in this kind of a discussion.

The counterintuitive notion that a capital gains tax cut would increase revenues is based on two premises. First, the historical record shows that a capital gains tax rate cut in 1978 increased revenues; and second, the body of the academic literature predicts such an increase.

It is my contention that both of these premises are false and that cutting tax rates on capital gains will not increase revenues.

Let me deal with these two premises in turn.

First of all, claims that the 1978 capital gains tax rate cut increased revenues are based on two errors: first, the failure to distinguish between the transient and the continuing effects of a capital gains tax change; and second, a failure to recognize other causes of changes in capital gains realizations.

A cut in capital gains tax rates will increase realizations for reasons that are purely temporary. If a future cut in capital gains tax rates is announced, just about anyone who plans to realize a gain will postone that realization until the tax cut takes effect.

That will make the impact of the tax cut appear larger temporarily.

Further, if an asset holder is sitting on the fence over whether to realize a gain, cutting tax rates will in effect move the fence and induce him to sell.

It is a totally different question, however, whether a capital gains tax cut will induce so much more realization, year in and year out, that it will more than offset its static effect and actually increase revenue.

When there is nothing to be gained by shifting a realization earlier or later, and once the figurative fence is again firmly planted on the ground, the remaining continuing effect of a capital gains tax cut is smaller than the transient effect.

So, looking over only a short time span can easily exaggerate the effects of the capital gains tax change.

Likewise, tax effects can be exaggerated by ignoring other determinants of capital gains realizations. Over the long haul, through tax increases and tax decreases, capital gains realizations have tended to follow the growth of the economy with further upward and downward swings propelled by the stock market.

Ignoring these fundamental determinants of realizations can make tax changes look more powerful than they are, rather like giving a jogger running to the east additional credit for the rotation of the earth.

I have appended a couple of graphs to my testimony that you might want to peruse at your leisure.

Now, how does this lesson illuminate the experiences of the 1978 and 1981 capital gains tax cuts?

First, it is not enough to say that a tax cut in year one increased revenues in year two. We need to look at years three and four in addition, at least.

Second, it is doubly wrong to attribute an entire year over year increase in capital gains to a tax cut. Capital gains will increase roughly in step with the economy, with or without a tax change.

And so, the only proper comparison is with what capital gains would have been in the absence of a tax cut, as difficult to determine as that might be.

And third, we must consider the very strong effects of the stock market in pushing realizations up and down as well.

Now, after the 1978 tax cuts and even before, there were a lot of numbers bandied about in terms of revenue estimates. And after the fact, once we got to see the experience on the basis of that tax change and also the 1981 tax change, it was time to look at the numbers and put up or shut up.

Let me refer you if I might to a table on page 4 of my testimony, which shows the Treasury Department's own estimates, after the fact, of the changes in revenue due to the capital gains tax cuts in 1978 and 1981.

There are some obvious points in the numbers in that table. First and foremost, these revenue figures, based on the actual experience following the 1978 and 1981 tax cuts, bear absolutely no resemblance to the claimed effects of capital gains tax cuts currently proposed.

Only the first year revenue pickup from the 1978 tax cut is appreciable, and even allowing for all of the inflation and real growth that has since occurred, it is not even in the same arena with the recent promises.

And second, that one appreciable revenue pickup figure is obviously only transient.

By 1980, the revenue gain from the 1978 law had essentially evaporated. The 1978 law experience thus gives no backing to claims of an ongoing revenue pickup.

But as clear as the 1978 law's record is, we should focus even more on the 1981 experience. The 1981 law bears marked similiarities to the circumstances under which the 1987 capital gains tax cut would take effect.

It took the 1981 cut, including ordinary tax rate decreases as did the recent tax reform bill, and also it followed on the heels of another capital gains tax change where there was already some unlocking.

I will just point out that the 1981 bill was a revenue loser from its very first day.

The CHAIRMAN. Thank you, Dr. Minarik. Along with the balanced viewpoint we try to get on this committee, we have a gentleman who may have a contrary point of view; and that is Mr. Mark

Bloomfield, who is President of the American Council for Capital Formation. It is your time at bat.

[The prepared statement of Dr. Minarik follows:]

# Statement of

Joseph J. Minarik
Senior Research Associate
The Urban Institute

I am pleased to respond to your request for testimony on the taxation of capital gains.

There has been some interest of late in reducing the maximum tax rate on long-term capital gains to increase tax revenues. This counterintuitive notion is based on two premises: first, that a capital gains tax rate cut in 1978 increased revenues; and second, that the body of the academic literature predicts such an increase. It is my contention that both of these premises are false, and that cutting tax rates will not increase revenues. Let me deal with these premises in turn.

## The Precedent of the 1978 and 1981 Capital Gains Tax Cuts

Claims that the 1978 capital gains tax rate cut increased revenues are based on two errors: first, a failure to distinguish between the transient and the continuing effects of a capital gains tax change; and second, a failure to recognize other causes of changes in capital gains realizations.

A cut in capital gains tax rates will increase realizations for reasons that are purely temporary. If a future cut in capital gains tax rates is announced, just about anyone who plans to realize a gain will postpone that realization until the tax cut takes effect; that will make the impact of the tax cut appear larger temporarily. Further, if an assetholder is sitting on the fence over whether to realize a gain, cutting tax rates will in effect move the fence and induce him to sell. It is a totally different question, however, whether a capital gains tax cut will induce so much more realization, year in and year out, that it will more that offset its static effect and actually increase revenue. When there is nothing to be gained by shifting a realization earlier or later, and once the figurative fence is again firmly planted in the ground, the remaining, continuing effect of a capital gains tax cut is smaller than the transient effect. Looking over only a short time span can easily exaggerate the effects of a capital gains tax change.

Likewise, tax effects can be exaggerated by ignoring other determinants of capital gains realizations. Over the long haul, through tax increases and tax decreases, capital gains realizations have tended to follow the growth of the economy, with further upward and downward swings propelled by the stock market. Ignoring these fundamental determinants of realizations can make tax changes look much more powerful than they are--rather like giving a jogger running toward the east additional credit for the rotation of the earth.

To illustrate both of these points, consider figure 1, which shows net long-term capital gain in excess of net short-term capital loss on individual income tax returns from 1960 through

1977, together with the gross national product (GNP). Note that realizations closely follow GNP in the early 1960s, then move ahead in 1965--some might say because of the passage of the 1964 tax cuts. But realizations go nowhere special in 1966, only to take a big jump with the rapid growth and booming stock market of the late 1960s. Realizations fall in 1969 and 1970--some would say because of the capital gains tax increase, some would say because of the recession. But they pick up again as soon as the economy and the market resume growth. They fall behind again in the deep recession of 1974-75, but pick up once more as the economy and the market recover.

To document the close relationship between capital gains and the stock market, figure 2 compares the annual percentage increase in realizations and that of the New York Stock Exchange index over the same period. The similarity of the patterns is obvious. What is also striking, however, is that any change in realizations possibly brought on by a change in the tax law--the 1964 rate reductions or the creation of the minimum tax in 1969, for example--is quickly reversed as fundamental economic determinants of capital gains resume control.

The obvious lesson here, as far as I am concerned, is that tax changes don't move realizations--at least not very much, or for very long. On the contrary, it is the stock market that moves realizations ahead of or behind their central tendency, which is the path of the economy as a whole.

How does this lesson illuminate the experiences of 1978 and 1981? First, it is not enough to say that a tax cut in year one increased revenues in year two; we need to look at years three and four, as well. Second, it is doubly wrong to attribute an entire year-over-year increase in capital gains to a tax cut; capital gains will increase roughly in step with the economy, with or without a tax change, and so the only proper comparison is with what capital gains would have been in the absence of a tax cut--as difficult to determine as that might be. And third, we must consider the very strong effects of the stock market in pushing realizations up and down as well.

With a Congressional mandate and following these ground rules, the Treasury Department assessed the impacts on revenues of the 1978 and 1981 capital gains tax cuts. Their estimated revenue effects in billions of dollars by year are as follows:

| | YEAR | | | |
|---|---|---|---|---|
| TAX CUT | 1979 | 1980 | 1981 | 1982 |
| 1978 | +0.9 | * | -0.1 | -0.2 |
| 1981 | N.A. | N.A. | -0.1 | -0.3 |

*Less than $50 million

There are several obvious points here. First and foremost, these revenue figures, based on the actual experience following the 1978 and 1981 tax cuts, bear absolutely no resemblance to the claimed effects of the capital gains tax cut currently proposed.

Only the first year revenue pickup from the 1978 tax cut is appreciable, and even allowing for all of the inflation and real growth that has since occurred, it is not even in the same arena with the recent promises.

And second, that one appreciable revenue pickup figure is obviously only transient. By 1980, the revenue gain from the 1978 law had essentially evaporated. The 1978 law experience thus gives no backing to claims of an ongoing revenue pickup.

But as clear as the 1978 law's record is, we should focus even more on the 1981 experience. The 1981 law bears marked similarities to the circumstances under which a 1987 capital gains tax cut would take effect:

-The 1981 law cut the maximum tax rate on capital gains from 28 percent, the same as its level now. Thus, while the 1978 law likely had a greater impact because the capital gains tax rates had been at a higher level, the 1981 law started from the same moderate point as would any new law.

-The 1981 law cut ordinary income tax rates as well as capital gains rates. Thus, there was perhaps less of a shifting of investment from assets that produce ordinary income to those that produce capital gain in 1981 than in 1978. That effect should hold now as well, given the substantial reduction of tax rates on ordinary income in the 1986 law.

-The 1981 law, following closely on the 1978 law's temporary unlocking of gains, could itself have less of a temporary unlocking effect; the shelves had just been cleared of much accrued appreciation. Similarly, any change of the law this year, following on the heels of the induced unlocking at the end of 1986, could have only a limited temporary unlocking effect.

Given these similarities between the 1981 experience and our current situation, it is instructive to note that the 1981 capital gains tax cut was a revenue loser from day one. Not even a temporary revenue pickup can be found to alter that conclusion.

Finally, the revenue increases cited above are, if anything, overestimates of the effects of the capital gains tax cuts. If a lower capital gains tax rate induces taxpayers to invest in assets that generate capital gains rather than ordinary income, capital gains realizations will go up, but ordinary income and total revenues will go down. Further, because the capital gains exclusion was one of the key ingredients in the making of tax shelters, expansion of the capital gains preference likely decreased revenue through increased tax sheltering as well.

In sum, the history of the last decade is not favorable to the revenue raising claims of capital gains tax rate cuts. Absent this historical precedent, arguments for capital gains tax cuts as a deficit remedy must rest on predictions in the empirical literature.

## The Academic Literature

The only recent argument for the revenue productivity of capital gains tax cuts on the basis of the literature in the field has been made by Lawrence Lindsey. I am in a good position to evaluate Professor Lindsey's paper, because my work is among the literature that Lindsey purports to summarize. And while I have every intention of being courteous and collegial in my comments, I must also be honest and frank.

My own work on capital gains taxation suggests that behavioral responses to tax changes are identifiable, but are much too small to reverse the static revenue impact. Confronted with this finding in his summary of the literature, Lindsey might have undertaken a critical evaluation of my methodology to justify his own position. Instead, he changed my results. Specifically, he drastically oversimplifies my computations, and then alleges that my research suggests that the establishment of a 15 percent maximum capital gains tax rate would lose virtually no revenue. (The effect of Lindsey's manipulation is to exaggerate the behavioral responses of moderate-income taxpayers.) Yet the very paper that Lindsey cites contains my own detailed simulation of the 1978 capital gains tax cuts, showing that they would lose revenue. Simulated with the same detail, the new proposal and the 1978 law would have the same effect. Lindsey could have tested his interpretation of my work on the 1978 tax law change, to see if he were accurately replicating my results, yet he chose not to.

Lindsey's questionable practices do not stop with my work. He summarizes two other papers, one by Martin Feldstein and one of his own, that indicate that after the capital gains tax increase in the Tax Reform Act of 1986 there will be virtually no realization of capital gains. Confronted with these outlandish results, Lindsey could have determined that the papers were incorrect, and chosen not to use them to simulate the new law or a proposed tax cut. Instead, again, he changed the results. (The effect of Lindsey's manipulations here is to reduce what would have been enormous predicted behavioral responses of virtually all taxpayers.) Here again, there was an opportunity to check his interpretation; Feldstein's paper included a simulation of the 1978 tax law change, which he predicted would cause capital gains realizations to immediately triple. (Six years and another capital gains tax cut later, they have yet to do so.) Lindsey could have checked to see if his interpretation of Feldstein's work agreed with Feldstein's own results, but he chose not to. There is every indication that all of Lindsey's characterizations of papers in the literature are as inaccurate as those of my work and of Feldstein's.

In sum, I see no reason to believe Professor Lindsey's predictions of revenue increases from capital gains tax cuts; his interpretation of the literature is demonstrably faulty. Further, the wide range of predicted results should be an implicit warning that econometric predictions of this sort are especially hazardous; Jane Gravelle of the Congressional Research Service has documented these risks in a recent paper.

## Conclusion

Obviously, revenue is not the only important factor in any tax policy decision; and in my view, subsidiary considerations make a capital gains tax cut even less attractive at this time. The Congress has just completed the most remarkable reform of the federal individual income tax since it was created in 1913, and the repeal of the capital gains exclusion was a vital element. Much of the complexity of tax administration was eliminated along with the payoff to conversion of ordinary income into capital gain. Much of the incentive to shelter income through manipulative investments was eliminated as well. These substantial improvements would disappear if the capital gains preference were reinstated.

The price that we paid for these administrative and fairness benefits was modest. The top-bracket tax rate of 28 percent that will be effective next year is the same as the capital gains tax rate that investors cheered in 1978--when inflation was more rapid than it is today. Thus, it is doubtful that the new law can be seen as a barrier to economic efficiency.

If anything, the risk is that a reinstatement of the capital gains preference would be seen as a serious breach of fairness. The Congress struggled to achieve a substantial reduction in marginal tax rates on all income, and its achievement has been applauded by most economists. Nonetheless, there has been some public unhappiness, notwithstanding the repeal of loopholes, about the large reduction in the statutory tax rates on the highest income recipients. In my view, given the repeal of loopholes, this criticism is unfounded. But I must concede that it would have far more credibility if the drastic reductions in ordinary tax rates were followed by still further reductions of capital gains tax rates. If the next step is to increase the top-bracket tax rates in the name of fairness, and the following step is to reinstate further loopholes as relief from the renewed pressure of high tax rates, then all of the benefits of tax reform--in fairness and efficiency--will fly out the window.

Despite all of these nonrevenue considerations, however, this hearing--on ways to comply with the budget resolution--is about revenue. And here, there is no doubt.

The proposal to cut capital gains taxes is supply-side economics--nothing more, nothing less. We have been there before. The 1978 capital gains tax cut was predicted to boost growth and productivity, and the 1981 tax cut was predicted to fill our treasury. Instead, we have had declining competitiveness, a bulging deficit, and a proliferation of tax shelters that have dashed public confidence in the fairness of our tax system. With the Tax Reform Act of 1986, we have a new tax law that rewards value in the marketplace, and taxes equally persons with equal incomes. Let us keep what we have achieved; let us not make the same mistake three times.

# Figure 1

Long-Run Determinants of Capital Gains

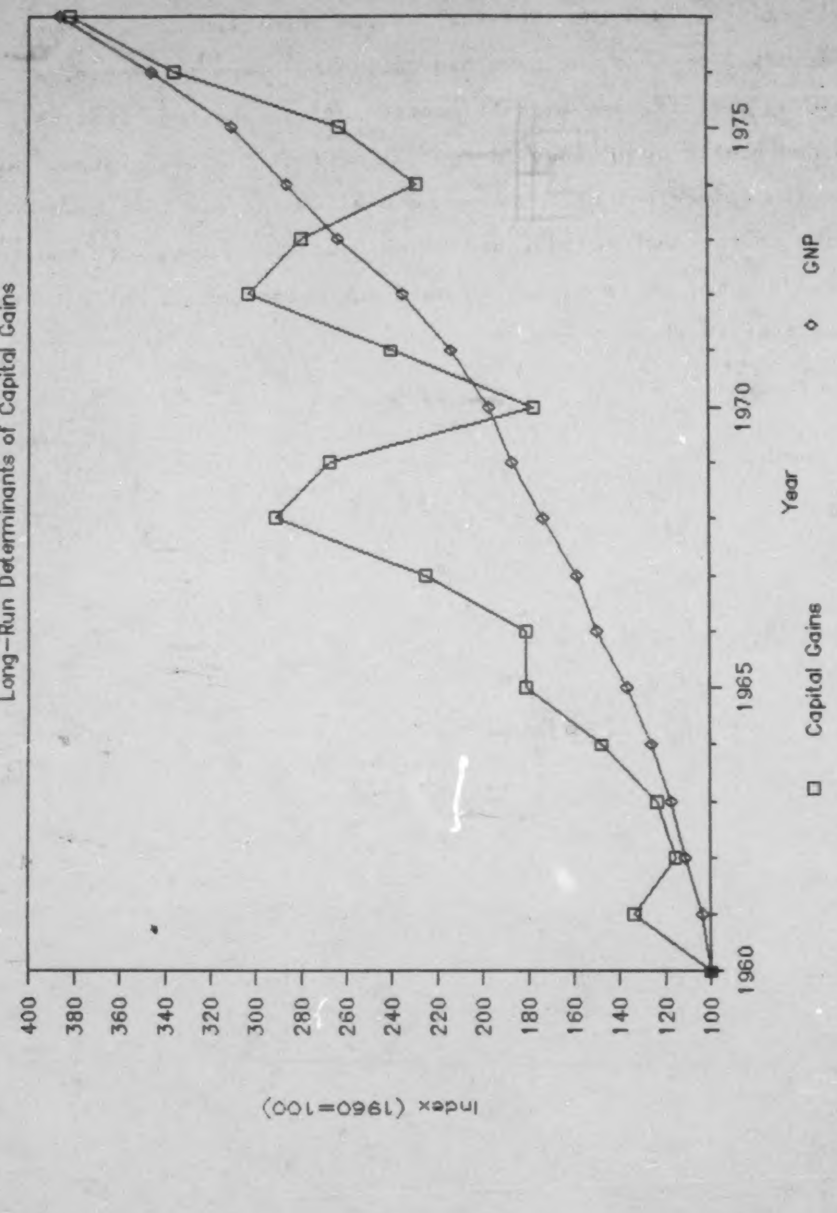
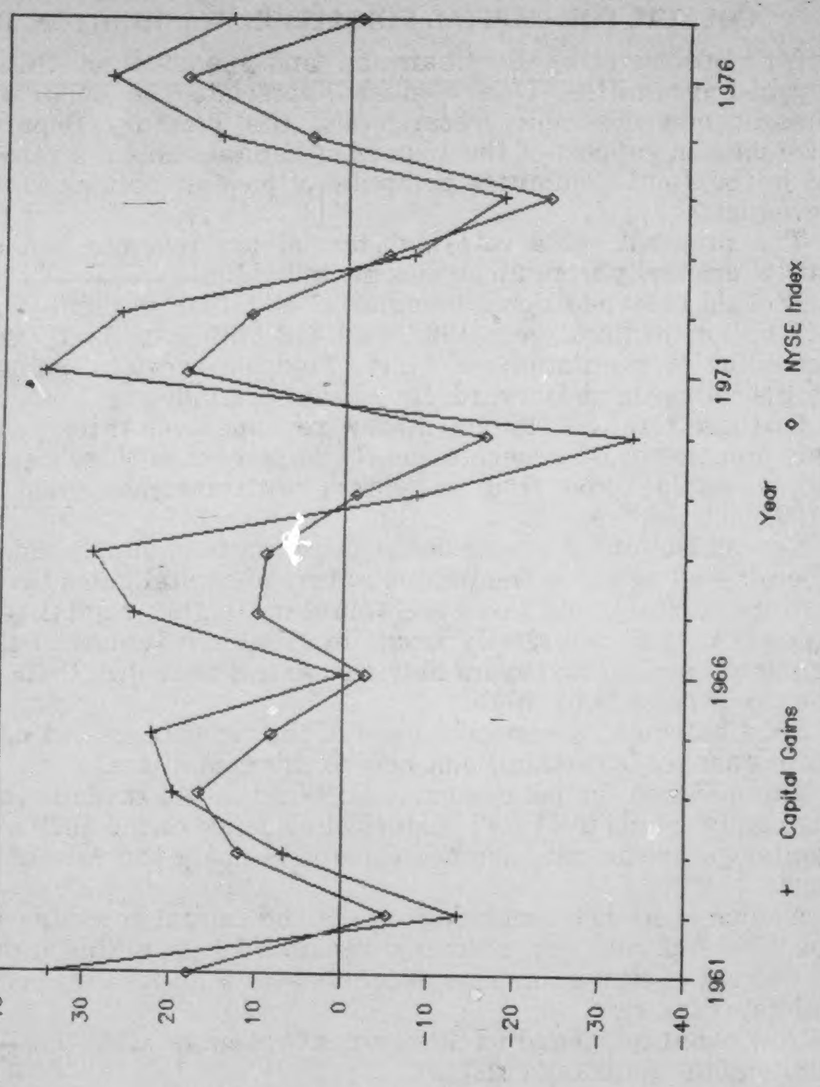


Figure 2

Capital Gains and the Stock Market



## STATEMENT OF MARK BLOOMFIELD, PRESIDENT, AMERICAN COUNCIL FOR CAPITAL FORMATION, WASHINGTON, DC

Mr. BLOOMFIELD. Mr. Chairman and members of this distinguished committee, I very much appreciate the opportunity to present new academic research and the Treasury Department's own data in support of the 15-percent capital gains tax rate included in the Joint Committee pamphlet of possible options to increase revenues.

The proposal could raise substantial tax revenue and does so fairly, primarily from upper income individuals.

It could raise additional revenues of $8 billion in fiscal year 1988, $11 billion in fiscal year 1989, and $12 billion in fiscal year 1990 according to simulations of Marty Feldstein's capital gains model by his colleague at Harvard, Dr. Lawrence Lindsey.

Of these total $31 billion in new revenue over three years that this proposal could generate, nearly 80 percent of these new tax receipts would come from taxpayers with incomes greater than $100,000.

Economists of all persuasions—conservatives, supply siders, and liberals—all agree on the unique nature of capital gains taxes.

Since capital gains taxes are voluntary, higher capital gains tax receipts do not necessarily result in greater revenues to the Government because taxpayers may choose not to realize their gains if the tax penalty is too high.

Mr. Chairman, the specific issue of the revenue impact of capital gains changes is certainly not new to this committee.

The question for policymakers is: What is the revenue maximizing capital gains tax rate? Historical evidence of the 1978 and 1981 capital gains tax cuts demonstrates it is not a top rate of 50 percent.

Academic studies conclude it is not the capital gains tax rates of the 1986 Act, and new academic research suggests that a proposed 15-percent capital gains rate approximates the revenue raising capital gains tax rate.

Now, what happened to Government revenues after the 1978 and 1981 capital gains tax cuts?

Although as a result of the 1978 and 1981 legislation the maximum capital gains tax declined from 50 percent in 1978 to 20 percent until this past year, revenues to the Treasury were 184 percent—184 percent—higher in 1985, the most recent data, than they were in 1978.

Inflation, economic growth, and the stock market cannot by themselves provide sufficient explanation for this dramatic increase in revenues coinciding with a dramatic decrease in capital gains rates.

As I said, receipts from capital gains increased from $9 to $26 billion over that period. Capital gains realized increased by 243 percent; and with all deference to Dr. Minarik, the Dow Jones average only increased 92 percent, and the economy increased only 77 percent.

So, you can see the tax rates play in important role.

Furthermore, lower capital gains rates produced a permanent, and not a temporary, search, as you can see in the numbers in the period 1978 to 1985.

On the other hand, the capital gains provisions of the 1986 Act resulted in substantial revenue losses, in particular in the period you are looking at—fiscal years 1988 to 1990.

An update of a February Treasury revenue estimate by the American Council, based on new April tax receipts, suggests revenue losses of as much as $6 billion over the fiscal year 1988–90 period.

And I mention that this is a very, very conservative estimate. The new and startling findings by Harvard Professor Lindsey, based on five leading academic and Government capital gains studies, are particularly relevant.

Three points. All but one of these studies predict revenue losses in the range of $27 billion to $105 billion under the 1986 Act over a 5-year time horizon, with Dr. Feldstein predicting $105 billion revenue loss.

These same studies predict revenue losses in the range of $17 billion to $65 billion over the 3-year budget period, with again Dr. Martin Feldstein predicting the higher of $65 billion.

And third, all but one of the studies on the sensitivity of capital gains realizations to tax rates imply revenue maximizing capital gains tax rates ranging from 9 to 21 percent.

In conclusion, the proposed 15-percent capital gains tax rate should be a front runner among revenue options before this committee for three reasons.

One, it is a powerful revenue raiser. Two, it extracts revenue from upper income taxpayers. And third, unlike almost all the other options before you, it is good for the economy.

Mr. Chairman, I also ask permission to have included in the record our more technical appendix to my testimony, which we finished yesterday, which addresses some of the econometric technical issues that Dr. Minarik included in his testimony.

The CHAIRMAN. Without objection, it will be done.

Mr. BLOOMFIELD. Thank you.

[The prepared statement of Mr. Bloomfield and the technical appendix follow:]

Statement of Mark A. Bloomfield, Esq.
President, American Council for Capital Formation
before the
Committee on Finance of the United States Senate
Friday, July 17, 1987

My name is Mark A. Bloomfield. I am president of the American Council for Capital Formation. I appreciate this opportunity to present testimony in support of a 15 percent capital gains tax rate. While I am prepared to make the capital formation case for this proposal, the thrust of my testimony will be the revenue-raising potential and the fairness of the 15 percent capital gains tax rate, which I trust are the main concerns of this committee as it weighs the pros and cons of various options to include in a balanced deficit reduction package.

This proposal meets two critical tests. First, it raises substantial tax revenue. Second, it raises much of that revenue fairly, primarily from upper income individuals rather than from those least able to bear an additional tax burden. The proposal could raise additional revenues of $8 billion in FY88, $11 billion in FY89, and $12 billion in FY90 according to simulations of Dr. Martin Feldstein's capital gains model by Professor Lawrence Lindsey of Harvard University. Of the total $31 billion in new revenue over three years, nearly 80 percent would be raised from taxpayers with incomes greater than $100,000.

Before I comment on this "15 percent option," I wish to commend Chairman Bentsen and this committee for moving promptly to comply with the reconciliation instructions in H. Con. Res. 93, the Concurrent Resolution on the Budget for Fiscal Year 1988. I share the views of most in this room that the federal deficit is the most serious economic problem facing this country today and applaud this committee's intention to act forthrightly on a balanced deficit reduction package.

The American Council for Capital Formation is a nonpartisan, nonprofit organization comprised of individuals, corporations, and associations united in their support of government policies to promote a strong economy. For more than a decade, we have focused much of our attention on the impact of tax policy on saving and investment. In particular, we have been involved in the debates of 1978, 1981, and 1986 about the appropriate taxation of capital gains. In recent months, we have devoted considerable time and resources to studying the revenue implications of the capital gains tax provisions of the Tax Reform Act of 1986. Today, I would like to share the results of this research work with you.

## THE NATURE OF THE CAPITAL GAINS TAX

The capital gains tax is a voluntary tax. Taxpayers alone can decide when to realize their capital gains. Capital gains tax rates do matter significantly to investors; in addition, they impact on government revenues.

Consider the example of two taxpayers, each of whom has just realized a $100 capital gain under the pre-1986 maximum federal capital gains tax rate of 20 percent. Uncle Sam collects $40 in this example, $20 from each taxpayer. Now, consider the same taxpayers, A & B, who face the new, higher maximum federal 33 percent capital gains tax rate under the '86 act. Taxpayer B may be reluctant to realize his gain because the government will take too large a share. As a result, his gain is "locked in." The federal government is deprived of revenue. And, thus, under the '86 act, Uncle Sam collects only $33 from both taxpayers compared to $40 under the pre-1986 lower capital gains tax rates.

In fact, if one looks at combined federal and state capital gains taxes, and evaluates the difference between the old and new rules, the potential "lock-in" effect is even more dramatic. For a middle income Hawaiian, the combined capital gains tax increases by 122 percent; for a similarly situated Oregonian by 118 percent; for a middle income New Jerseyite by 96 percent; and for a middle income New Yorker by 149 percent, according to Arthur Andersen & Co.

The point is simple and intuitive. Economists of all persuasions--Keynesians, conservatives, supply-siders, and liberals--agree. Since capital gains taxes are voluntary, higher capital gains tax rates do not necessarily result in greater revenues to the government because taxpayers may choose not to realize their gains if the tax penalty is too high.

The question policymakers should ask is: what is the revenue-maximizing capital gains tax rate? Certainly, as the historical experience with the '78 and '81 capital gains tax changes demonstrates, it is not a top rate of 50 percent. The overwhelming weight of academic research now concludes that it is not the capital gains tax rates of the '86 act. New academic research suggests that the proposed 15 percent capital gains tax rate approximates the revenue-maximizing capital gains tax rate.

## RECENT HISTORICAL EVIDENCE

The revenue impact of a lower capital gains tax is not a new issue to this committee. When this committee debated the dramatic 1978 capital gains tax cut, proponents claimed it to be a "revenue gainer," opponents argued it to be a "revenue loser," others believed it to be a "revenue wash." The then secretary of the Treasury asserted that "the measure would cost the Treasury more than $2 billion annually."

In an attempt to clarify the revenue debate over higher and lower capital gains taxes, Congress mandated in the Revenue Act of 1978 that the Treasury Department prepare a report on the impact of capital gains tax reduction of 1978. Specifically, Treasury was asked to report to the Congress on the effect of capital gains tax changes on income tax revenue.

Of course, subsequent to the 1978 act, which reduced the maximum individual federal capital gains tax from almost 50 percent to 28 percent, the 1981 act cut the tax further to a top capital gains tax rate of 20 percent, which remained in effect through 1986.

What does the historical experience of the '78 and '81 capital gains tax cuts tell us?

First, let's look at actual Treasury capital gains tax receipts for the period 1978-1985. Although the maximum capital gains tax declined from 50 percent in 1978 to 20 percent until this year, revenues to the Treasury were 184 percent higher in 1985 (latest available data) than in 1978. Inflation and GNP growth cannot by themselves provide sufficient explanation for this dramatic increase in federal revenues coinciding with a dramatic decrease in capital gains tax rates.

Second, let's look at the extremely cautious summary of the Treasury Department's capital gains report, Capital Gains Tax Reductions of 1978 (September 1985). It concluded that: "the reduction in tax rates on capital gains in the 1978 act caused a substantial increase in revenue from capital gains taxes in the first year after the tax cut."

What the recent historical experience with the '78 and '81 capital gains tax cuts proves makes common sense. Within some reasonable range, lower capital gains taxes increase the flow to government coffers (the '78 and '81 acts) and, conversely, higher capital gains taxes can decrease government revenues (the '86 act).

## CAPITAL GAINS PROVISIONS OF THE '86 ACT

In brief, the Tax Reform Act of 1986 increases the individual federal capital gains tax rate from a maximum of 20 percent to 28 percent (or 33 percent for joint returns between $71,900 and $149,250 and up to 49 percent for some investors). It is the largest capital gains tax rate increase since 1934.

What is relevant for the hearings today is the impact of these capital gains changes on government revenues, especially since this committee has been instructed to raise $64.3 billion over the next three fiscal years ($19.3 billion in FY88, $22.0 billion in FY89, and $23.0 billion in FY90).

Let's look at the official government revenue estimates of the capital gains provisions of the '86 act.

To the best of my knowledge, Joint Committee on Taxation revenue estimates are unavailable. The "Blue Book" or General Explanation of the Tax Reform Act of 1986, does not identify a separate revenue impact for the capital gain and loss provisions. A footnote explains that this effect is included in the rate reduction budget estimates. According to a Treasury Department estimate of February 1987, the short-term revenue impact of the '86 capital gains tax changes is $12.5 billion in additional revenue in FY87. That is now history. The Treasury also predicts revenue losses in the critical next two fiscal years, in the amount of -$1.5 billion in FY88 and -$0.1 billion in FY89. (See Appendix A, column 1.)

Part of what the Treasury predicted makes sense. Many investors accelerated their profit taking at the end of calendar year 1986 (FY87) to take advantage of the much lower capital gains tax rates under the old law. Having accelerated these gains, taxpayers obviously will realize fewer gains for the next three to four years. More importantly, the higher capital gains tax rates under the '86 act will extend investors' holding periods on their remaining portfolios and encourage them not to realize gains at all. This effectively creates a massive "lock in" that will rob the federal government of revenue.

The February Treasury Department capital gains revenue estimate of the '86 act was done before the unparalleled surge in April Treasury receipts, to a large extent dominated by taxes on capital gains realized last year.

If one extrapolates from this new raw data, especially the April federal receipts and similar increases in state tax receipts from 1986 activities, to update the Treasury's earlier estimates, the impact of the '86 act is even more dramatic. Our analysis, at the American Council for Capital Formation, is that the new data suggests that the Treasury numbers should be revised to show $15-25 billion in increased revenues in FY87, as compared to the original $12.5 billion estimate. This also translates into a revenue loss of as much as -$6 billion over the FY88-90 period.

Let's now look at some new and startling academic findings on the revenue implications of the 1986 capital gains tax changes. Earlier this year, Harvard Professor Lawrence Lindsey simulated the revenue impact of the '86 act capital gains changes for FY87-91 based on the findings of five of the recent leading academic and government investigations of capital gains taxation. The studies all examined the responsiveness of taxpayers to changes in capital gains tax rates. Dr. Lindsey simulated the revenue impact of the new capital gains tax rules using a total of 13 sets of behavorial parameters identified in the studies. (See Appendix B.)

Three of Dr. Lindsey's findings are particuarly relevant as this committee acts to meet the mandated revenue targets of $64.3 billion for FY88-90 under budget reconciliation.

First, all but one of these studies predict revenue losses in the range of -$27 billion to -$105 billion under the '86 act compared to prior law over the FY87-91 period, with Dr. Feldstein's model forecasting the -$105 billion revenue decline. The average of the academic and government studies shows a revenue loss of -$38.7 billion over the FY87-91 period, according to Dr. Lindsey. A similar study by Peat Marwick projects revenue losses averaging -$34.2 over the five year period. (See Appendices A and B.)

Second, the same studies predict revenue losses in the range of -$17 billion to -$65 billion under the '86 act compared to prior law over the next three years (FY88-FY90), again with Dr. Feldstein's model suggesting the largest or -$65 billion revenue decline. The average of the academic and government studies predicts a revenue loss of -$31.7 billion over the FY88-90 period. Peat Marwick's study projects revenue losses of -$37.4 billion over the three year budget period. (See Appendices A and B.)

Third, according to Professor Lindsey's analysis, all but one of the academic and government investigations of the sensitivity of capital gains realizations to tax rates imply revenue maximizing capital gains tax rates ranging from 9 percent to 21 percent.

In conclusion, the preponderance of the evidence suggests that one, the '86 act capital gains provisions will result in revenue losses for the next several fiscal years; two, the long run level of capital gains tax revenues will be lower under the '86 act than the old law; and three, a carefully constructed 15 percent capital gains tax rate, effective date of enactment or 1/1/88, whichever is earlier, could provide a needed revenue bonus for FY88-90 and beyond.

## THE 15 PERCENT SOLUTION

I urge this committee to consider the proposed 15 percent capital gains tax as a departure point for the crafting of a capital gains tax reduction as an innovative element of the $64.3 billion revenue-raising package for FY88-90, with which you are charged.

The 15 percent rate is suggested only because it falls in the middle of the range of the 9 percent to 21 percent revenue-maximizing capital gains tax rate in the Lindsey study. An obvious alternative approach would be to enact a 40 percent exclusion for capital gains which, applied to the '86 act marginal tax rate brackets, results in a range of capital gains tax rates from 9 percent to 19.8 percent.

Based on the findings of the five recent leading academic and government investigations of capital gains taxation, Professor Lindsey estimates a new 15 percent capital gains tax rate increases capital gains revenues an average of $4 billion in FY88, $5 billion in FY89, and almost $6 billion in FY90. Professor Lindsey's simulation of the 15 percent proposal with Dr. Feldstein's methodology yields revenue gains of almost $8 billion in FY88, $11 billion in FY89, and $12 billion in FY90. (See Appendix A).

A significant capital gains tax cut effective, for example, July 1, 1987, perhaps to a maximum 15 percent could be a bold element of a balanced deficit reduction package. Such action would also not require any significant reopening of the tax code since Congress, in 1986, wisely left the capital gains structure in the internal revenue code.

## THE FAIRNESS ISSUE

All the historical data plus the recent academic research done by Professor Lindsey indicate that lower capital gains tax rates coincide with higher government revenues from upper income taxpayers.

In the period 1978-85, when capital gains taxes were reduced from 50 percent to 20 percent, total individual capital gains tax receipts increased from $9.1 billion to $25.9 billion. The bulk of this new revenue for Uncle Sam came from upper income taxpayers. Total capital gains realized by those with annual incomes over $100,000 increased by 500 percent between 1978 and 1984 (latest data available) compared to a 93 percent increase for those with incomes below $100,000.

Dr. Lindsey's research shows that most of the revenue increase comes from high income taxpayers. As mentioned earlier, Dr. Lindsey projects average revenue gains of $4 billion (FY88), $5 billion (FY89), and almost $6 billion (FY90) for a total of $15 billion over the FY88-90 period under the 15 percent proposal. Taxpayers with incomes of $100,000 and above account for over 70 percent of the revenue increase. Those with incomes of $200,000 and above account for nearly 40 percent of the revenue gain.

Simulations of Dr. Feldstein's model of the 15 percent proposal show a similar pattern of revenue gain: 8 billion (FY88), $11 billion (FY89), and $12 billion (FY90) for a total of $31 billion over the three year period. Taxpayers with incomes of $100,000 and above account for almost 80 percent of the revenue increase. Those with incomes of $200,000 and above account for more than 50 percent.

It is important to realize that the tax yield on unrealized, locked in capital gains is precisely zero. It is wrong to describe a capital gains tax rate reduction as a "tax break for the wealthy" when in fact the taxes paid by this sector will multiply dramatically.

## CONCLUSION

Although I have focused my testimony appropriately on the revenue implications of a low capital gains tax rate, there is, of course, a strong capital formation case to be made for a significant capital gains tax differential.

The 1978 and 1981 capital gains tax cuts proved to be an economic success story. These cuts improved the investment climate, facilitated a record number of new stock offerings, and bolstered corporate equity values and employment gains across the entire spectrum of the economy. Our international competitors recognize the contribution a capital gains tax differential can make to new risk capital, entrepreneurship, and new job creation. A new Arthur Andersen & Co. study comparing tax rates on portfolio stock investment among eleven major industrialized countries and six Pacific Basin countries, reveals that, in 1987, U.S. capital gains taxes are higher than almost all surveyed countries. Japan, Germany, and South Korea, among others, exempt from taxation all long-term capital gains from portfolio stock investments.

I also would be remiss if I did not note other capital gains impacting items in the pamphlet prepared for this hearing. For instance, neither the 1987 rate freeze proposal nor the items setting the top marginal rate at 33 percent contain a capital gains rate differential. An alternative staff option to set the top rate at 38.5 percent does leave the capital gains rate at the present 28 percent statutory level. While we, along with many others, consider marginal tax rate increases a breach of faith with last year's tax reform compact, we do urge that, if you undertake such an initiative, it is incumbent upon you to restore a meaningful capital gains differential at a 20 percent or lower rate.

In closing, the proposed 15 percent capital gains tax rate, suggested by several members of this committee, should be a front-runner among your revenue options. It is a powerful revenue-raiser. It extracts tax revenue from upper income taxpayers, rather than the low and middle income taxpayers. Yet, unlike almost all the revenue options before you, it is good for the economy.

## Appendix A : Capital Gains Revenue Estimates
($ in billions)

| | CAPITAL GAINS PROVISIONS OF THE TAX REFORM ACT OF 1986 | | | PROPOSED 15% RATE | |
|---|---|---|---|---|---|
| Fiscal Year | (1) Treasury | (2) Lindsey Average | (3) Peat Marwick Average | (4) Feldstein | (5) Lindsey Average |
| 1987 | $12.5 | $ 6.0 | 9.2 | | |
| 1988 | (1.5) | (9.1) | (16.4) | $ 7.7 | $ 3.8 |
| 1989 | (0.1) | (10.7) | (14.2) | 11.0 | 5.3 |
| 1990 | 3.4 | (11.9) | (6.8) | 11.8 | 5.7 |
| 1991 | 7.4 | (13.0) | (6.0) | 12.7 | 6.0 |
| 1988-90 | $ 1.8 | ($31.7) | ($37.4) | $30.5 | $14.8 |
| 1987-91 | $21.8 | ($38.7) | ($34.2) | | |

1/ Column 1 is the Treasury Department's estimate (February, 1987) of the revenue impact of the capital gains provisions of Tax Reform Act of 1986. Totals may not add due to rounding.

2/ Column 2 is the average revenue impact of the capital gains provisions of the Tax Reform Act of 1986 as calculated by Harvard professor and National of Bureau of Economic Research fellow Dr. Lawrence Lindsey. Professor Lindsey's calculation draws upon the studies by Treasury (cross section-1985); Lindsey (1987); and Auten and Clotfelter (1982) and the assumption that taxpayers acted on the knowledge of capital gains tax increases effective 1/11/87.

3/ Column 3 is the average revenue impact of the capital gains provisions of the Tax Reform Act of 1986 as calculated by the Policy Economics Group of Peat Marwick. The Peat Marwick calculations are based on six analyses. These are: Treasury (cross section-1985); Feldstein, Slemrod and Yitzhaki (1980); Minarik (1981); Lindsey (1987); Congressional Budget Office (time series-1986); and Treasury (time series-1985). The Peat Marwick analysis was prepared for the American Council for Capital Formation Center for Policy Research in June, 1987.

4/ Column 4 is Professor Lawrence Lindsey's estimate of the revenue impact of the proposed 15 percent capital gains tax rate (effective 1/1/88) based on the methodology used in the Feldstein study (1980).

5/ Column 5 is Professor Lindsey's calculation of the average revenue impact of the 15% capital gains tax proposal based on several prominent studies. These are: Treasury (cross section-1985); Lindsey (1987); Auten and Clotfelter (1982); Feldstein, Slemrod, and Yitzhaki (1980); and Minarik (1981).

Appendix B

American Council for Capital Formation
Center for Policy Research

April 1987

## SPECIAL REPORT

# Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions

by Lawrence B. Lindsey*

*During the congressional consideration of the Tax Reform Act of 1986 (TRA) there was much controversy about the revenue impact of the elimination of the capital gains tax differential. Proponents of the repeal claimed significant tax revenue increases would result. Others, pointing to historical data and analytical work, said the increase in capital gains tax rates would be a revenue loser. To further a constructive debate on TRA's impact on capital gains tax revenues the ACCF Center for Policy Research is pleased to summarize below the findings of a recent paper, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions," by Dr. Lawrence B. Lindsey. The paper contains simulations of the effect of TRA for calendar years 1986-1991 and for fiscal years 1987-1991 using 13 different behavioral models. These models were derived from the academic findings of Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki; the Department of Treasury; Lawrence Lindsey; Gerald Auten and Charles Clotfelter; and Joseph Minarik. The Lindsey paper will be published as a working paper by Harvard University and by the National Bureau of Economic Research, as well as presented at the annual meeting of the National Tax Association—Tax Institute of America on May 19, in Washington, D.C.*

This paper examines the likely effects of the Tax Reform Act of 1986 on capital gains realizations and tax revenue. The major conclusions of the study are:

- The Tax Reform Act of 1986 involves the largest capital gains tax rate increase, at least since 1934, and probably since the advent of the income tax in 1913.
- All but one of the academic investigations of the sensitivity of capital gains realizations to tax rates imply that revenue maximizing rates range from 9 to 21 percent.
- In spite of the apparent disparity of findings, the academic literature suggests that it is extremely unlikely that the Tax Reform Act of 1986 will produce any additional capital gains tax revenue, and will most likely produce less revenue than resulted from the much lower tax rates of the old tax law. All but one of the academic studies predict revenue losses in the range of $27 to $105 billion compared to prior law over the FY1987-1991 period. For FY1988 and 1989, the combined revenue losses range from $11 to $42 billion.

The study begins by evaluating the effect of the federal tax reform bill on marginal tax rates of long-term capital gains. It shows that taxpayers with incomes under $30,000 will generally see a tripling of their capital gains tax rates. Taxpayers with incomes between $30,000 and $200,000 will see their marginal tax rates on capital gains double. Those taxpayers earning over $200,000 will see an increase in tax rates of about 75 percent. In total, the average marginal tax rate facing capital gains recipients will rise from about 9 percent under old law to more than 21 percent under the new tax law. Weighted by the amount of capital gains received, the average federal marginal tax rate will rise from a bit under 15 percent to 27 percent. (When the impact of changes in state tax rates are included the rate increases are even greater.)

The study applies these federal tax rate changes to the findings of five of the leading academic investigations of capital gains taxation. The five studies all examined the responsiveness of taxpayers to changes in their capital gains tax rates. They relied on widely different data bases and produced a wide range of results.

The study reporting the greatest responsiveness of taxpayers was done by Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki. They used detailed tax return data on the sale of common stocks to compute the effective tax rates of a taxpayer's long term gains. This 1980 paper was published in the *Quarterly Journal of Economics*. The next greatest response of taxpayers was reported in the 1985

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This special report is one of a series of papers on capital formation issues published to further public debate on economic policy. For additional copies write to ACCF Center for Policy Research, 1850 K Street, N.W., Suite 400, Washington, DC 20006, or call (202)293-5811.

*Report to the Congress* by the Department of Treasury on the capital gains tax changes of 1978. This document reported that the large capital gains tax reductions of that year produced more capital gains revenue than would have been received under the earlier set of higher tax rates. The third greatest amount of taxpayer responsiveness was reported in Lawrence Lindsey's 1986 paper on 18 years of capital gains taxation. This study is forthcoming in a *National Bureau of Economic Research* volume on taxes and capital formation. The next greatest degree of taxpayer sensitivity to tax rates was a 1982 piece by Gerald Auten and Charles Clotfelter published in the *Quarterly Journal of Economics* which relied on work they had undertaken while at the Department of Treasury's Office of Tax Analysis. The least amount of taxpayer responsiveness was reported in a paper by Joseph Minarik published by *The Brookings Institution*. This piece was a reexamination of the work of Feldstein, Slemrod, and Yitzhaki which used a different econometric technique and a different model of realization behavior.

It should be stressed that these authors investigated capital gains tax rate variations that were much smaller than those contemplated in the current tax reform. Furthermore, much of the variation in tax rates which these authors investigated was among upper income taxpayers. It is not certain that taxpayers in lower income brackets will respond in the same fashion as those in upper brackets. Nor is it certain that taxpayers will respond to the largest capital gains tax rate increase in history in the same proportion as the response they've demonstrated to much smaller capital gains tax changes in the past. In addition, outside the scope of this paper but relevant to investor behavior is the total federal and state tax on capital gains. Unless state corrective action is taken, the new combined federal and state capital gains tax rate will range from a low of 29.7 percent in Pennsylvania to a high of 37.9 percent in New York for taxpayers in the 28 percent federal tax bracket. Therefore, the best interpretation of the results is as a range of likely taxpayer behaviors, and particular attention should not be given to any single estimate.

In order to provide the widest possible investigation of potential taxpayer responses, a total of 13 sets of behavioral parameters are obtained from the five studies. These parameters estimate both the permanent, long-run effect of capital gains tax rates and the temporary effect of capital gains tax changes on taxpayer behavior. Taxpayers are modeled both as considering past tax rates as well as future tax rates in making their decisions.

Of the 13 sets of assumptions, 12 predict that the *permanent* level of capital gains tax revenues will be lower under the new law than under the old law. The 13th set of assumptions, based on Minarik's work, suggests that capital gains tax revenues will be virtually unchanged under the new law. The apparent revenue neutrality in the Minarik model is the result of major tax increases on lower income capital gains recipients offsetting modest tax revenue reductions by upper income recipients who will realize fewer gains than under prior law.

Of the 12 models predicting lower permanent levels of revenue, 11 predict that the revenue will also be lower in the five years of the current budget cycle: FY1987-FY1991. The only model predicting an increase in the current five year period is a variant of the work of Auten and Clotfelter. This model assumes that taxpayers are extremely sensitive to *future* increases in capital gains tax rates. As a result, this model predicts that taxpayers realized so many capital gains in late 1986 (2.5 times the normal level) that the added revenue offset the future declines in tax revenue. These results would have to be considered extreme.

The table presented below indicates the revenue maximizing level of tax rates and the percent decline in revenue in FY 1988 under the Tax Reform Act relative to prior law predicted by each of the studies investigated.

| Research Findings | Revenue Maximizing Capital Gains Tax | % Change in 1988 Capital Gains Revenue |
|---|---|---|
| Feldstein, Slemrod & Yitzhaki | 9% | −72% |
| Dept. of Treasury | 12% | −48% |
| Lindsey | 18% | −29% |
| Auten & Clotfelter | 21% | −19% |
| Minarik | 28% | + 1% |

The evidence provided in the paper is overwhelming that a marginal tax rate reduction for long term gains will increase capital gains tax revenue. The only positive revenue gains predicted in the various models resulted from accelerated realizations in late 1986 in anticipation of future tax rate increases. To the extent that these revenues enhance the total taxes collected under the tax reform act, it should be noted that these tax revenues have already been received. Therefore, prospective capital gains tax rates in the range of 9 to 21 percent can capture the benefits associated with permanently lower rates without sacrificing the temporary revenue gains of the tax rate increases enacted in the Tax Reform Act of 1986.

The **Chairman**. Dr. Minarik, in looking over these numbers on capital gains, I notice a recent study by the Arthur Andersen Accounting Firm and, in turn, the recent article in the Economist entitled "Capital Punishment in America."

They shows that Japan and Germany exempt capital gains from taxation. Italy, and the Netherlands also exempts capital gains. France has a 16 percent capital gains rate, Canada has a 17.5 percent rate, Sweden 18 percent, and we have a 28 percent rate.

Considering that Japan and Germany, totally exempt long-term capital gains from taxation, do you think that creates a disadvantage for us?

Dr. **Minarik**. Mr. Chairman, there are a number of differences, not just in the taxation of capital gains, among the nations that you named.

Germany, for example, has a periodic wealth tax. Japan does not even have a stock market developed at all along the same lines as what we do.

The United States also has the——

The **Chairman**. Would you repeat that? I didn't understand that. What does Japan have?

Dr. **Minarik**. Japan does not have a widely open equity market—a stock market—like what we have. The debt-equity ratios of firms in Japan are much, much higher; a lot more of the financing takes place not through equity, but rather through debt. It is an entirely different kind of an operation.

The **Chairman**. Those things are granted, except their stock market is certainly developing fast. Go ahead.

Dr. **Minarik**. It may very well, Mr. Chairman, but I might also add that the United States has by far the lowest statutory corporate tax rate of all the nations you named, and also the lowest tax rate on receipts of dividends from corporations by individuals.

So, what we are dealing with is not a single feature with respect to a tax law but rather a whole package of features that affect capital formation.

I think our package compares very favorably with those around the world.

The **Chairman**. You made a point that I would like for you to develop for me a little. You said one of the arguments against restoring preferential treatment for capital gains is the complexity of adding such a preference to the tax law. Would you elaborate on that for me?

Dr. **Minarik**. A lawyer I know used to say that the efforts that he put out for his clients could be divided into two parts. Part one was converting ordinary income into capital gains. Part two was converting capital losses into ordinary losses.

He said each took up about 50 percent of his time. What we have done in the course of this tax bill is at least to reduce the taxpayer and administrative efforts that would have to be exerted on the question of converting ordinary income into capital gains to obtain preferential treatment.

The **Chairman**. Mr. Bloomfield, would you have any comment on that?

Mr. **Bloomfield**. Yes, if I could comment about the Japan situation. Dr. Minarik is correct that we ought to be concerned about the overall package, but I think that there is a lot of evidence out, a lot of new research done by John Chovin at Stanford and others, that our cost of capital is higher than that of most of our competitors including Japan.

Tax policy is an important part and capital gains plays a part.

With regard to the complexity, Mr. Chairman, as you know, you did not eliminate the capital gains provisions from the Tax Code. They are there right now in the Tax Code.

So, you do have complexity in the Tax Code on capital gains right now because you have the restrictions on capital gains losses.

So, with regard to changing the Tax Code per se, the Congress did not take capital gains out of the Tax Code—capital losses—and only tax capital gains as ordinary income and kept the restrictions on losses.

Dr. **MINARIK**. Mr. Chairman, if I may, just to add, if there is no advantage for individuals to convert ordinary gain ordinary income into capital gain, I doubt that there will be too much administrative action in attempting to deal with that problem whether the distinction is in the Code or not.

The **CHAIRMAN**. Well, I suppose there would be if you have a capital loss. You would want to show a capital gain to try to offset that.

Dr. **MINARIK**. That is definitely the case.

The **CHAIRMAN**. All right. The Senators in the order of arrival this morning are Baucus, Moynihan, Daschle, Chafee, Riegle, and Bradley. Senator Baucus.

Senator **BAUCUS**. Thank you, Mr. Chairman. Gentlemen, I am just interested in some facts here. What percent of charitable organizations or tax exempt organizations' budget is attributable to investment income?

I know there are all kinds of tax exempt organizations. We have churches and so forth; but I am wondering how much of the budget, generally, is attributable to investment income?

Bishop Stewart, perhaps you can address that?

Bishop **STEWART**. Specifically speaking for the pension fund area, most of the larger religious bodies have over 50 percent of the income with which they pay pensions that comes from investment sources.

The other comes from yearly contributions coming in each year which help obviously in the outgo. When it comes to what you call denominational headquarters budgets on a nationwide basis, they range any where from approximately a minimum of 10 up to about 22 or 23 percent, I think, in that area where investment income is part of a national headquarters office.

In the individual parishes, of course, that can vary throughout the country from a parish that has no investment income to obviously Trinity Church Wall Street.

So, it is a little hard to give any definitive figure, but we are particularly concerned that so many of the programs we have undertaken are financed through investment income sources.

Senator **BAUCUS**. Should there be any limit on the tax exempt status of a tax exempt organization's investment income? Or say a church's? Should there be any limit?

What if, say, a tax exempt organization grew so that 80 to 85 percent of its receipts were tax exempt income, and virtually unrelated to the tax exempt organization?

Should there be any limit on the tax exempt status?

Bishop **STEWART**. Obviously, if it is unrelated to the original intent and purpose, there would really be a question whether it was a taxable income on a very different ground, as the House Ways and Means Committee is exploring.

But even those institutions we have that have unusually large investment income, you will discover, if you will analyze their budgets, are using it in very creative community causes and ways.

I could say in New York such a place is Trinity Church New York, with the incredible kind of social work and agencies that it supports.

Senator **BAUCUS**. Thank you.

Mr. **O'CONNELL**. I wonder if I might comment, Senator Baucus.

Senator **BAUCUS**. Yes.

Mr. **O'CONNELL**. It is the unattainable dream of every voluntrary organization to have an endowment that will fund its activities. In the specific area of foundations, though, you have the ultimate of your example where all of the income of most foundations is endowment.

And this particular proposal would in essence cut the grantmaking capacity of foundations by 5 percent.

It is a real question whether it is the intent of this group—as I have watched you in your admirable work—whether that is anything like your intent, to cut the capacity of foundations by 5 percent, as one small means of dealing with the very large problem of the deficit.

Senator **BAUCUS**. Thank you and thank you, Mr. Chairman.

The **CHAIRMAN**. Senator Moynihan.

Senator **MOYNIHAN**. For a moment there, Mr. Chairman, I thought that Senator Baucus was going to propose confiscating the church lands and estate. [Laughther.]

Could I first welcome Bishop Stewart back? And Mr. Chairman, if I might express the great appreciation which this committee should feel for your help to us in the 1986 Tax Bill in working out, I think, what in the end was a good solution to the 403(b) organizations, such as you represent.

And if you were to know the magnitude of the pensions which most members of the clergy live on, you would recognize how important it was. I just want to thank you for that, Bishop Stewart.

And I would say to Mr. O'Connell and Mr. O'Neill there are concerns that we are particularly interested in here.

If you will step back just a moment and look at this decade, it is at once both a little chilling and a little fascinating. If Dr. Minarik will agree, I think one of the great economic minds of this century was that of Joseph Schumpeter, who absent the 1930s Depression might be seen as a man larger in his understanding than Edison Cane surely ever was.

And Schumpeter did forecast an end to the liberal economic arrangements of the 19th and 20th centuries, but not as Marx had forecast at all. He said the end of these arrangements will come by the steady conquest of the private sector by the public sector.

And if you are ever going to get a feeling of this proposition as inexorable, you have to watch it taking place in Washington in the year of Ronald Reagan.

In that last tax bill, we stripped universities of thier status as "exempt persons" for purposes of the exempt financing. Columbia, Stanford, NYU, Southern Methodist University—they are now engaged in "private activities."

And one heard the argument that there was no immediate, real loss in becoming classified as a private activity; so what are you worried about? But here one year later we say we will start taxing your endowments.

And the tax bill took away from nonprofit institutions the capacity to receive the benefits of gifts which were deductible at fair market value.

The cost, Mr. O'Connell, the National Bureau of Economic Research has estimated, one-seventh of your contributions. That is called the conquest of the private sector by the public sector.

And now we want to tax your endowments. If we took away the amount of money equal to your History Department, Mr. O'Neill, and we got you to close down your History Department, then there would be no record of what happened. Wouldn't that be right? [Laughter.]

And isn't that the plan. Isn't that the plan, sir?

Mr. O'NEILL. Yes.

Senator MOYNIHAN. You are a distinguished jurist and an authority on the First Amendment. What is going on here?

Mr. O'NEILL. Unless one were to rewrite it from scratch, that is certainly true. There are various ways of measuring this loss. Senator, for us, it would, for example, in one year exceed the amount that we now provide from all institutional sources for student financial aid.

That is obviously much less than the total, the larger part coming from Federal sources. But it would exceed the amount that we provide from all institutional sources.

For an institution like Columbia, we have a reliable estimate that the 1-year cost of this tax would be in the range of $16 million.

Senator MOYNIHAN. Right.

Mr. O'NEILL. Even for a public institution like ours, it would be in the neighborhood of 8 to 10 percent of our educational and general costs, or even taking all the auxiliaries into account, 4 to 5 percent.

But it is more than just the cost of the proposition, it is the philosophy of it.

Senator MOYNIHAN. What the philosophy turns to is dependence on the State; is it not?

Mr. O'NEILL. Yes, and also to discourage certain ways in which States like ours and eight or ten others have recently tried to encourage and to leverage private giving by matching through State funds.

There is a curious sense in which this would represent one public hand taking away that which another public hand at the State level has tried to encourage.

Senator **Moynihan**. But I urge you to brush up on your Schumpeter; it is all around you. We are out to destroy the independent sectors of this economy.

Mr. **O'Connell**. Senator, may I comment very briefly?

Senator **Chafee**. I would just like to ask: We are out collectively——

Senator **Moynihan**. Collectively and unintentionally——

Senator **Chafee**. Don't have that "we" encompass anybody on this side. [Laughter.]

Senator **Moynihan**. All right, good. I am glad to hear that.

Mr. **O'Connell**. I wonder if I could comment just very briefly. I spend about five percent of my time with visitors from other countries who are trying to figure out how they can develop in their societies this third nonprofit——

Senator **Moynihan**. And now it is too late.

Mr. **O'Connell**. No.

Senator **Moynihan**. We had it and lost it.

Mr. **O'Connell**. Yes, but very often they are looking to find what are the symbols by which their governments can send the message that having this third, buffer or nonprofit sector is a part of freedom of their society.

The tax factor is just one, but it is the messages that are not getting through in those other countries and are decreasingly getting through in our country that we, as a whole, believe that these three sectors are a very much part of the uniqueness of the American experience.

Senator **Moynihan**. I would just make one point. In the last tax bill, we took institutions—the private institutions of higher education in this country—and changed the status of their bonds from that of exempt persons to that of private activities. A huge event.

The **Chairman**. Thank you very much, Senator. Senator Daschle.

Senator **Daschle**. Thank you, Mr. Chairman. I think the members of this panel have certainly made a compelling case; but I am confused at least a little bit with regard to your opposition to the 5 percent, especially Mr. O'Neill's statement that this represents a radical departure from precedent.

It is my understanding that the 2-percent tax is still in existence; is it not?

Mr. **O'Neill**. But only for foundations, and that has only the most indirect effect on us.

Senator **Daschle**. What you are saying is that the expansion itself is what represents this radical departure?

Mr. **O'Neill**. And in terms of university endowments and income from other presently tax exempt sources, it really does represent a major change in philosophy of approach toward what tax exempt status means.

Mr. **O'Connell**. Could I just comment very quickly on that?

Senator **Daschle**. Yes.

Mr. **O'Neill**. The tax on foundations, as the record will show, Senator, was designed only to cover the cost of the regulation and monitoring of foundations. That is why the tax was reduced from the 4 percent to the 2 percent and why now there is serious question about even the 2 percent because it is producing six to seven times what is necessary for that intended regulation. It was a user tax.

Senator **Daschle**. That was the only stated purpose? Revenue was never indicated as——

Mr. **O'Connell**. That stated purpose. You can find it in the record.

Senator **Daschle**. Let me ask a second question related to that. There have been alleged accounts of substantial abuse in the utilization of tax exempt status. Do you believe, given your experiences, that there are accounting methods to be used either by the IRS or by organizations themselves which could preclude the charges of abuse that have been somewhat frequently reported?

Mr. **O'Connell**. Senator, with all great respect to the Bishop, I have to say in my 30 years as a community organizer, almost all of the worst of the abuses—the worst of the abuses—have come in the name of religion.

And then you get into the questions of separation of church and State. The National Charities Information Bureau is now redoing their standards, and I think they will be even tighter. They are good standards.

We have a responsibility with you, and I accept that responsibility, to do everything possible to weed out the charletons.

Senator **Daschle**. What would you suggest "everything possible" should include, that we are not doing now?

Mr. **O'Connell**. I would suggest going after those who are clearly guilty. You have the examples now that Congressman Pickle has clearly uncovered, with out help, of those who have used their organizations to engage in gross political activity or to be used as a conduit for the collection of money for the sale of arms when that was illegal.

I say make examples of them.

Senator **Daschle**. Bishop Stewart.

Bishop **Stewart**. I would like to say we would say "amen" that we would be the 28 religious bodies represented by Church Alliance in the forefront of those who would say we want monies received to be used responsibly for the exact tax exempt purpose for which we secured the tax exemption.

And if it is for nonrelated business things that the groups are doing, then by all means let us encourage the House Ways and Means Committee to tax such kinds of activities; but we are talking primarily about the five percent on programs that are clearly integral to the operations of churches, such as a pension fund which is operated by trustees who are elected by the National Church Convention.

And we are under all kinds of accounting procedures with accounting firms and open books. We would say "amen." Let us go after those who are——

Senator **Daschle**. You are saying it is a matter of enforcement. Is that it? There is nothing wrong with the regulations that are set out, but it is simply a matter of enforcing the regulations a lot more effectively?

Bishop **Stewart**. Yes.

Senator **Daschle**. And you don't disagree with that, Mr. O'Neill?

Mr. O'NEILL. I think our experience is much more to the same effect. Yes, we would concur.

Mr. O'CONNELL. I think there is merit in looking at Congressman Dorgan's proposal, though, as a revenue raiser in the matters of full disclosure and compliance.

Senator DASCHLE. Thank you, Mr. Chairman.

Senator BAUCUS. Thank you. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. First, I want to welcome Bishop Stewart, who I had the privilege of knowing when he was in our State. He did a wonderful job, and now he is going on to higher things; and we congratulate him on that.

Bishop, getting right down to the nitty-gritty and to the practical effect this would have—this five percent excise tax—on your organization, do I understand that it might indeed make it more difficult for you to honor the commitments you have already made to retired clergy?

Bishop STEWART. Yes. Each succeeding year, we have tried to keep up with the cost of living, and we have nearly succeeded.

We have made promises based on actuarial assumptions of income that we will receive over the forthcoming years. We have made those commitments to our retired clergy and their prospective widows.

If you take five percent of our investment income, which in our instance is 58 percent of the money that goes to retirees, you have appreciably cut out automatically 3 percent of our income at least; and we would have to backtrack on those promises.

Senator CHAFEE. Fine. I just want to thank each of you who have testified on this particular point. I must say I don't think it has gathered much of a head of steam, but maybe it is just as well to cut it off early, that is, the suggestion that this 5 percent excise tax be levied.

Thank you very much, Mr. Chairman.

Senator BAUCUS. Thank you. Senator Bradley.

Senator Bradley. Thank you, Mr. Chairman. Dr. Minarik, I have a question for you, but first let me ask Mr. Bloomfield a question. Your sixth point in your summary was citing findings by Harvard Professor Lindsey, based on five leading academic and Government capital gains studies. And then, you summarize your results of looking at Dr. Lindsey's work. Is that correct?

Senator BLOOMFIELD. That is the basis of it, but there is additional support in the testimony.

Senator Bradley. All right. Now, as I understand, Dr. Minarik, one of the studies involved was your study., Is that correct?

Dr. MINARIK. That is correct, Senator.

Senator Bradley. So, the information that Mr. Bloomfield is attesting to is Professor Lindsey's look at five studies, one of which is yours?

Dr. MINARIK. That is correct.

Senator Bradley. Now, in your testimony, you say rather startling things about Dr. Lindsey's look at your study.

In fact, you say on page 8 that he changed the results.

Dr. MINARIK. That is correct, Senator.

Senator Bradley. Now, that is farily blunt. Could you explain how?

Dr. MINARIK. Well, in as plain a way as I can. I attempted to estimate the relationship between realizations of capital gains and tax rates across the population of taxpayers in a fashion that allowed for a great deal of variation from taxpayer to taxpayer and individual circumstances, including the size of portfolio, the tax rate, the amount of income from other sources, and so on.

What Professor Lindsey did was to pick out one particular type of taxpayer and do, say, a simplified relationship between only the tax rate in that particular taxpayer's realizations of capital gains and then apply that relationship to all taxpayers.

I have made some computations across taxpayer characteristics to try to find out how Professor Lindsey's interpretation of my work differ from my own work; and the differences are fairly substantial.

I might add, however, that I did the same kinds of computations with respect to Professor Feldstein's paper and found that the differences there were even more substantial.

As a matter of fact, I think the net result of Professor Lindsey's, I would say as thoughtfully as I can, oversimplification of the research by the other economists that he cited, was to greatly compress the range of findings that those people had to induce an appearance that there was some kind of a consensus with respect to the outcomes here.

In fact, if those studies were used literally, if the findings were applied directly, you would find a tremendous range of opinion on the outcomes of revenue with respect to changes in capital gains tax rates.

So, I think he paints a picture of a consensus that isn't there. I think he also tends to push those figures in a direction that suggests a large revenue increase, which I think the research does not support.

Mr. BLOOMFIELD. Senator Bradley, at some point may I have the opportunity to respond to that?

Senator Bradley. Yes. I want to ask you a couple of questions, too. You asserted that from the lower capital gains rate the wealthy would pay more tax; and by that I assume you mean that the amount of tax coming from incomes above $150,000 or $200,000 would be greater with a lower capital gains tax than it would be with a higher capital gains tax. Is that correct?

Mr. BLOOMFIELD. That is correct.

Senator Bradley. Now, is it not also true, though, that the after-tax income distribution would be much worse?

Mr. BLOOMFIELD. No, sir. It is not. The numbers that I related to in terms of where the additional money could come from—our simulation of the NBER model at Harvard—they also simulated the after-tax burden on capital gains under the 1986 Act in a 50-percent rate——

Senator BRADLEY. Not the after-tax burden—the after-tax income. In other words, when we do tax policy and we pass laws, we get distribution tables. How will this change affect this group? How much better or worse will they be if we make this change?

It might very well be true that over $200,000 will pay more in total dollars because they will have more transactions; but it doesn't necessarily follow from that that their after tax income will be much lower.

Mr. **Bloomfield**. In fact, Senator, I would like to refer—and I can have it included in the record—the table done by the NBER model which refers to percent distribution of individual capital gains under the 50 percent by adjusted income group. And it refers to the Tax Reform Act and the 15 percent; and it breaks it down by decimal matter, and there is not much of a shift by adjusted income group.

I understand that if you reduce the tax, they may have more money; but in terms of what the Joint Committee will use in comparing current law with the 15 percent, the shifts are insignificant. They vary a little bit, but the shift is very insignificant in terms of the way the Joint Committee will use that.

Senator **Bradley**. Do you agree with that, Dr. Minarik?

Dr. **Minarik**. Not really. One thing that Professor Lindsey's simulation does, in Mark's partial defense; it blows up everybody's capital gains, I think, by unrealistic amounts.

However, I think there is a concentration at the upper end of the income scale; and if you look at the number of dollars of additional after-tax income for a taxpayer because of this proposed change in the capital gains tax rate, you would find that there is a tremendous windfall to people with tremendous amounts of wealth.

Senator **Bradley**. And that is possibly because over 50 percent of the capital gains taken are taken of people with more the $200,000 in income?

Dr. **Minarik**. Capital gains income is highly concentrated at the upper end of the income scale.

Senator **Bradley**. Thank you.

Senator **Baucus**. Dr. Minarik and Mr. Bloomfield, listening to each of you, I have this feeling that this is like the Irish question or the Mideast question or the Pakistan/India question. I mean, it is not factual; it is religious. [Laughter.]

Mr. **Bloomfield**. Mr. Chairman, could I have the opportunity to respond to Dr. Minarik's testimony very briefly?

Senator **Baucus**. Before you do, I would like to know frankly if either of you agree on anything? [Laughter.]

That is, this committee is trying to determine, among other things, whether we should reduce or raise capital gains rates.

One of you has one view; the other has a diametrically opposed view. And each of you cites facts and figures and studies and authority that makes it a bit difficult for this committee to conclude, on a rational basis—as opposed to a religious basis—what to do.

I am wondering if each of you could point to some facts, some studies, some something, that each of you agrees on to help us to decide for ourselves which if you tends to be more accurate than the other.

So, do either of you agree on anything that is constructive and helpful here?

Mr. **Bloomfield**. First of all, Dr. Minarik and I do agree—I guess it was about six months ago we briefed some foreign tax experts from around the world—and I guess we both briefed them, and we will find out whether we agree or disagree in terms of what the result would be.

But in terms of a specific answer to your question——

Senator BAUCUS. Yes, my question. Can you suggest something that we might look at that would help us determine?

Mr. BLOOMFIELD. I suggest one piece, and that is an article—a set of arguments—which is the Journal of Economics—a quarterly which I will have inserted in the record—which is essentially a comment on Dr. Minarik on Dr. Feldstein, and then Dr. Feldstein commenting on Dr. Minarik.

But I would also suggest——

Senator BAUCUS. Dr. Minarik, what do you have that we could look at that the two of you could agree on because, obviously, it is not going to help if each of you suggest something that is different?

Dr. MINARIK. Well, Senator, I can suggest an area where I agree at least with the Administration. I would refer you to a Report to the Congress on the Capital Gains Reductions of 1978 from the Office of the Secretary of the Treasury, Office of Tax Analysis, dated September 1985, in particular page 178, table 4.12, which is the table which I lifted directly and put into my testimony.

It shows, after the fact, the Treasury Department estimate of the revenue effects of the tax rate cuts on capital gains in 1978 and 1981.

And I would urge you to look at those numbers.

Senator BAUCUS. Thank you both very much. I appreciate it. Thank you.

[The Journal of Economics quarterly article follows:]

# THE EFFECTS OF TAXATION ON THE SELLING O CORPORATE STOCK AND THE REALIZATION OF CAPITAL GAINS: COMMENT*

JOSEPH J. MINARIK

In a recent article in this *Journal*, Martin S. Feldstein, Joel Slemrod, and Sl Yitzhaki [FSY] find that marginal tax rates have a powerful effect on the realiz of long-term capital gains on corporate stock, and project that a tax cut similar tc enacted in 1978 should triple realizations and increase tax revenues. This com finds that an econometric error caused FSY to overstate the elasticity of realiza to tax rates by a factor of 51. Corrected and refined estimates show that tax rate will not increase realizations sufficiently to increase tax revenues.

## INTRODUCTION

In their article, "The Effects of Taxation on the Selling of C porate Stock and the Realization of Capital Gains," Martin S. Fe stein, Joel Slemrod, and Shlomo Yitzhaki [1980] provide a qu titative analysis of a vitally important subject. The continuing c bate on capital gains tax policy has depended crucially on—but h been conducted in virtual ignorance of—the sensitivity of realiz tions to marginal tax rates.

Unfortunately, Feldstein, Slemrod, and Yitzhaki commit a b sic econometric error that causes them to overstate the tax ra elasticity of capital gains realizations by a factor of 51. As will b demonstrated below, the correction of this error shows that reduc tions in capital gains tax rates would stimulate realizations far les than has been claimed and would reduce rather than increase ta revenues.

The first section of this comment briefly recaps Feldstein, Slemrod, and Yitzhaki's methodology and findings. The second section explains their econometric error and how it can be corrected. The third section provides alternative econometric estimates and a sim-

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*Henry J. Aaron, Barry Bosworth, David G. Hartman, Robert W. Hartman, Jerry A. Hausman, Nancy E. O'Hara, Joseph A. Pechman, James M. Verdier, James W. Wetzler, and two anonymous referees provided helpful suggestions, but should not be implicated in any errors. John Kozielec of the Internal Revenue Service kindly provided the data on 1981 capital gains realizations. Katharine J. Newman programmed the regressions; Mimi Schade and Andy Hemstreet prepared the graphs; Timothy A. Cohn, Laurent R. Ross, and J. Edward Shephard also assisted, under the supervision of Arthur Morton and Nancy E. O'Hara. Susan Woollen and Linda Brockman typed the manuscript. The support of the National Science Foundation is gratefully acknowledged. Views expressed herein are the author's alone and should not be attributed to the Congressional Budget Office or to the National Science Foundation.

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*The Quarterly Journal of*

ulation of the revenue effect of the capital gains tax cut of the Revenue Act of 1978. A brief conclusion follows.

## ESTIMATES OF THE EFFECTS OF TAXATION

Feldstein, Slemrod, and Yitzhaki (hereafter FSY) used the U. S. Treasury's 1973 Capital Assets File (a stratified sample of tax returns with realized capital gains) in conjunction with the 1973 Individual Tax Model File (a stratified sample of all tax returns) to estimate the effects of marginal tax rates on the realization of long-term capital gains on corporate stock. They fitted a number of regression equations, and found no tax rate effect for the entire population of shareholders (identified through the receipts of dividends). However, when the sample was truncated to those shareholders with at least $3,000 of dividends (which translates, through the 1973 average dividend yield of 3.06 percent, to a portfolio of about $100,000 of corporate stock), a very strong tax rate effect emerged. Their key equation is presented as equation (1) in Table I. The age dummy variable takes the value of 1 if the extra exemption for taxpayers at least 65 years old is claimed on the return. The natural logarithms of adjusted gross income (*AGI*) and dividends are also included as independent variables. *TAXFSY* is an approximation of the taxpayer's actual last dollar tax rate on long-term capital gains (that is, the additional tax that would be due if the taxpayer realized one additional dollar of long-term gains) estimated through an instrumental variables technique, using the taxpayer's first dollar (that is, the additional tax due on the first dollar of realized long-term gains) and predicted last dollar (based on an average amount of capital gain for the taxpayer's income and dividend class) capital gains tax rates as instruments. The first-stage equation is not reported. No statistics on the goodness of fit of the main equation are reported.

The equation shows a sizeable effect of tax rates on realizations. The coefficient of the tax variable indicates that a ten-percentage point cut in the capital gains tax rate would increase the ratio of gains to dividends by 4.97. Using this result, FSY claim that capital gains tax cuts would generate so much additional trading and realization of gains that they would increase tax revenues. A simulation based on their estimated coefficient indicates that reducing the highest marginal tax rate on capital gains in 1973 to 25 percent would have tripled realizations.

## ENDOGENOUS SAMPLING

The 1973 Capital Assets File, which FSY used in their study, is based on a stratified sample of tax returns for income year 1973. The sample was chosen on the basis of *AGI*, with a significant variation in sampling rates ranging from 100 percent for returns with *AGI* either negative or greater than $200,000, to 1 in 10,000 for the more prosaic returns with *AGI* positive but less than $10,000. Apart from negative income returns, sampling rates rise sharply and monotonically as *AGI* increases. Weights equal to the inverse of the sampling rates are provided on the file.

The elasticity of realizations to the marginal tax rate, calculated at the point of means from the summary statistics reported by FSY, is −3.75.[1] However, independent tabulations of the same data file show that those summary statistics are unweighted. An elasticity based on weighted statistics would be far more appropriate, especially considering that FSY use their coefficients for a simulation of the revenue effects of changes in capital gains tax rates using the weighted data file. Using tabulations of the weighted file, the FSY coefficients yield an estimated elasticity at the point of means of the population with portfolios of $100,000 and over, as opposed to the stratified sample of the same group, of −22.57![2]

The average tax return with at least $50,000 in dividends (or a portfolio of at least $1,500,000 of corporate stock) has a last dollar tax rate on capital gains of 20.6 percent and a ratio of long-term stock gains to dividends of 0.265. Thus, if FSY's result is correct, an increase in the marginal tax rate on gains of only 0.6 percent, from 20.6 to 21.2 percent, would be enough to cause the average shareholder with at least $1,500,000 of stock to stop realizing gains completely![3] Alternatively, a tax cut of only 0.6 percent would more than double his realizations! This truly remarkable result begs for examination.

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[1] Based on FSY's reported mean gains-dividends ratio of 3.50, the mean last dollar tax rate of 26.4, and the tax coefficient of −0.497. FSY's standard error for the −0.497 coefficient is −0.038, allowing for a two-standard-deviation range of elasticities from −3.18 to −4.32.

[2] Based on the weighted mean gains-dividends ratio of 0.295, the weighted mean last dollar tax rate of 13.39, and FSY's −0.497 tax coefficient. The range of elasticity estimates using two standard errors of the coefficient is from −19.11 to −26.01.

[3] The change in the tax rate, 0.6 percent, times the tax rate coefficient, −0.497, reduces the gains-dividends ratio by 0.2982, to a value less than zero. The two-standard-error range of tax changes necessary to stop realizations is 0.46 percent to 0.63 percent. The open-ended high dividend class was chosen for this example because it realizes the most gains in absolute terms. However, this class has a gains-dividends ratio only 0.03 less than the average of all returns with dividends of at least $3,000 (0.265 compared to 0.295), and so the computation noted above is quite representative of FSY's estimated sensitivity for all taxpayers.

FSY fit their equations using unweighted ordinary least squares. This method is correct in the conventional setting in which a sample is stratified according to an independent variable in a regression, as is illustrated impressionistically in Figure I. In this case, sampling rates (and thus the frequency of sampled, circled points in the graph) vary systematically as the tax rate changes. (It is immaterial, from an econometric point of view, whether the sampling rates increase or decrease as the tax rate increases.) An unweighted least squares line fitted through the sampled and circled points is an unbiased estimate of the relationship for the entire population. However, FSY neglect to consider that their sample is stratified according to the dependent variable, not the independent variable, as is shown impressionistically in Figure II. All else equal, tax returns with larger capital gains, and thus a greater *AGI*, are more likely to appear in the sample.[4] In the general case of stratification on the dependent variable, the direction of the bias on the estimate of the slope is indeterminate. In this case, as Figure II suggests, a negative relationship between the tax rates and realized capital gains would be systematically overstated. Using weighted least squares rather than ordinary least squares would eliminate the bias, and that is the method used in this comment.[5]

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[4] In fact, this understates the case. An unknown number of tax returns were sampled at even higher rates than would be justified on the basis of *AGI* alone because they had capital gains greater than *AGI* (due to the presence of business losses). A brief tabulation of sampling rates by long-term stock gain or loss (based on 1973 returns) will show that Figure II, simple as it is, accurately represents the problem with FSY's analysis:

| Long-term stock gain or loss class | Average sampling rate |
|---|---|
| Loss or $0 | 1 in 86.5 |
| 1–2,500 | 1 in 140.1 |
| 2,500–5,000 | 1 in 106.2 |
| 5,000–10,000 | 1 in 64.6 |
| 10,000–20,000 | 1 in 51.0 |
| 20,000–30,000 | 1 in 35.4 |
| 30,000–50,000 | 1 in 18.7 |
| 50,000–100,000 | 1 in 12.3 |
| 100,000–200,000 | 1 in 6.2 |
| 200,000–500,000 | 1 in 2.4 |
| 500,000–1,000,000 | 1 in 1.5 |
| 1,000,000 and over | 1 in 1.0 |
| ALL | 1 in 72.6 |

[5] See Appendix I.

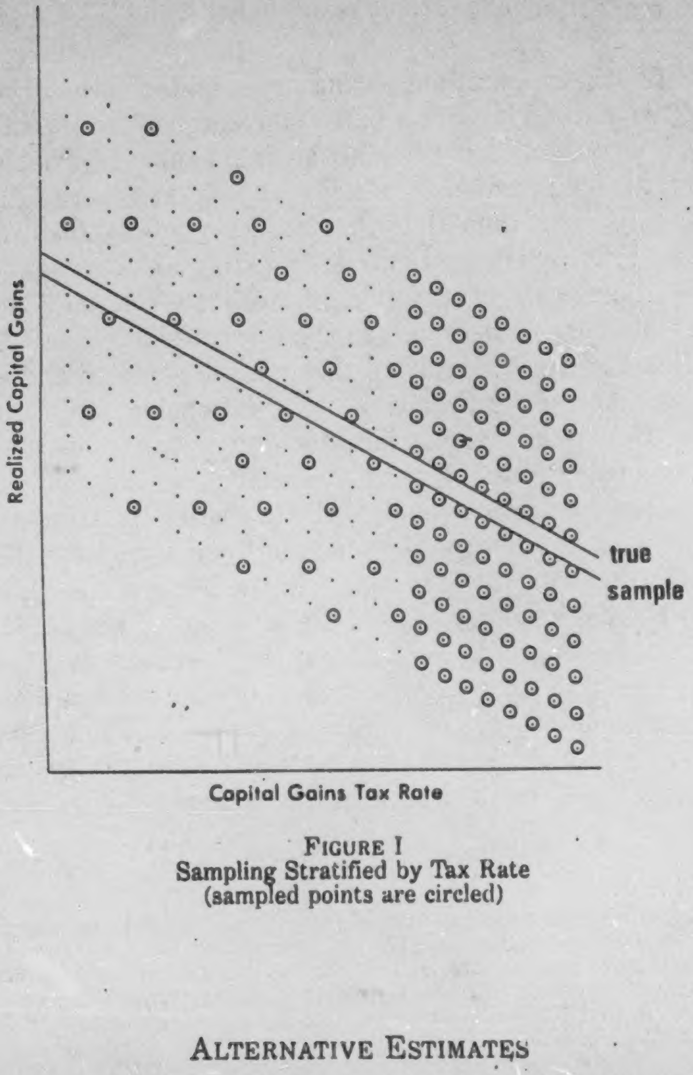

FIGURE I
Sampling Stratified by Tax Rate
(sampled points are circled)

## ALTERNATIVE ESTIMATES

Tables I and II show the effects of a number of changes in the FSY regression analysis made in a step-by-step fashion. The results demonstrate that changing from ordinary to weighted least squares, as was shown to be necessary by the analysis above, yields much smaller estimates of the elasticity of capital gains realizations to tax rates.

The population in all of the equations, like that in FSY, is all tax returns with dividends greater than $3,000, and thus (at average 1973 yields) with portfolios of at least $100,000 worth of corporate stock. The dependent variable, again as in FSY, is the ratio of stock gains to dividends.

Equation (2) in Table I is my replication of the FSY equation

TABLE I

UNWEIGHTED REGRESSION RESULTS ON REALIZATIONS OF LONG-TERM STOCK GAINS, 1973

| Independent variables | Dependent variables: long-term stock gains[a] (equation numbers) (1) | (2) | (3) | (4) |
|---|---|---|---|---|
| Constant | 35.0 | 27.530 | 30.169 | N.A. |
| | (26.316) | (12.192) | (24.434) | |
| Age dummy | 0.176 | 0.345 | 0.355 | N.A. |
| | (0.499) | (1.008) | (1.041) | |
| Log (*AGI*)[b] | −0.504 | −0.006 | −0.796 | N.A. |
| | (4.308) | (0.064) | (10.744) | |
| Log (Dividends) | −1.23 | −1.626 | −1.229 | N.A. |
| | (10.336) | (14.618) | (10.849) | |
| *TAXFSY*[c] | −0.497 | −0.342 | N.A. | N.A. |
| | (13.113) | (20.333) | | |
| *TAXM*[c] | N.A. | N.A. | −0.246 | N.A. |
| | | | (17.018) | |
| Constant[a] | N.A. | N.A. | N.A. | 81.110 |
| | | | | (20.887) |
| Age dummy[a] | N.A. | N.A. | N.A. | 5.108 |
| | | | | (1.635) |
| Dividends[a] | N.A. | N.A. | N.A. | 4.057 |
| | | | | (8.770) |
| Dividends$^2$[a] | N.A. | N.A. | N.A. | −0.001 |
| | | | | (1.609) |
| Adjusted gross income[a,c] | N.A. | N.A. | N.A. | −0.024 |
| | | | | (3.402) |
| Adjusted gross income$^2$[a,c] | N.A. | N.A. | N.A. | $-1.252(10^{-6})$ |
| | | | | (2.472) |
| *TAXM* times dividends[a,c] | N.A. | N.A. | N.A. | −0.123 |
| | | | | (6.816) |
| *TAXM* times *AGI*[a,c,d] | N.A. | N.A. | N.A. | $1.460(10^{-4})$ |
| | | | | (0.426) |
| *Summary Statistics:* | | | | |
| Corrected $R^2$ | N.R. | 0.021 | 0.029 | 0.036 |
| Corrected standard error | N.R. | 27.262 | 27.149 | 27.056 |
| Elasticity at point of means | −22.57 | −15.53 | −11.35 | −16.83 |
| Elasticity for \$3,000 ≤ dividends < \$10,000 | −19.05 | −13.11 | −9.49 | −26.85 |
| Elasticity for \$10,000 ≤ dividends < \$20,000 | −31.89 | −21.94 | −16.14 | −19.46 |

TABLE I *(continued)*

| Independent variables | Dependent variables: long-term stock gains[a] (equation numbers) (1) | (2) | (3) | (4) |
|---|---|---|---|---|
| Elasticity for $20,000 ≤ dividends < $50,000 | −32.38 | −22.28 | −16.58 | −11.81 |
| Elasticity for dividends ≥ $50,000 | −38.63 | −26.58 | −20.05 | −12.03 |

*Sources.* Equation (1), Feldstein, Slemrod, and Yitzhaki [1980]. Others, Internal Revenue Service 1973 Capital Assets File.

a. Divided by dividends.

b. *AGI* net of actual long-term and short-term stock gains plus predicted long-term gains.

c. Tax rates in regressions expressed as an integer number of percentage points.

d. *AGI* net of actual long-term stock gains.

N.A. = Not applied.

N.R. = Not reported.

*t*-statistics in parentheses.

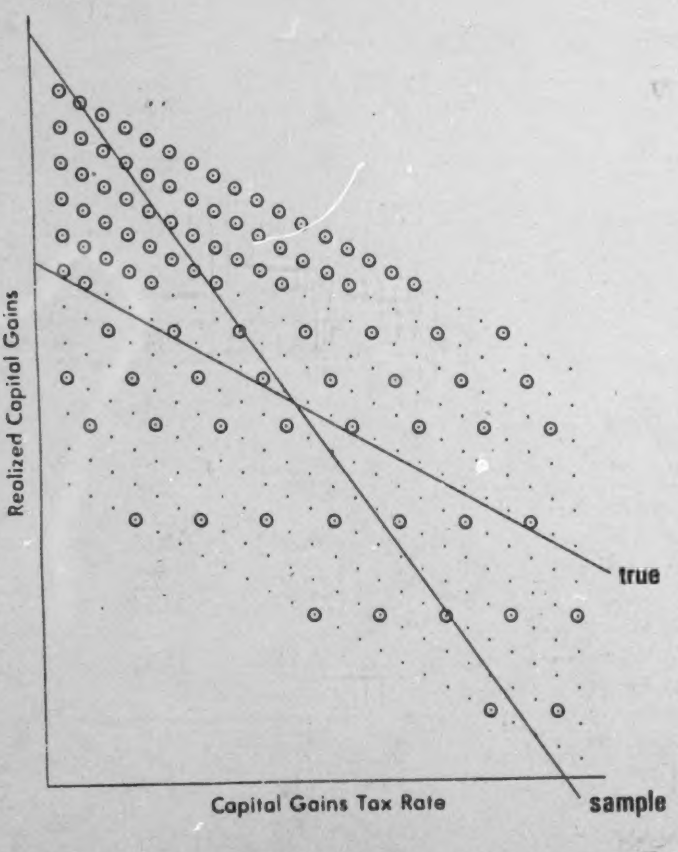

FIGURE II
Sampling Stratified by Income
(sampled points are circled)

### TABLE II

### WEIGHTED REGRESSION RESULTS ON REALIZATIONS OF LONG-TERM STOCK GAINS, 1973

| Independent variables | Dependent variables: long-term stock gains[a] (equation numbers) (1) | (2) | (3) |
|---|---|---|---|
| Constant | −0.955 | 1.196 | N.A. |
| | (2.157) | (3.003) | |
| Age dummy | −0.303 | −0.323 | N.A. |
| | (4.999) | (5.290) | |
| Log(*AGI*)[b] | 0.048 | −0.165 | N.A. |
| | (4.278) | (4.723) | |
| Log(Dividends) | 0.097 | 0.136 | N.A. |
| | (2.425) | (3.290) | |
| *TAXFSY*[c] | −0.039 | N.A. | N.A. |
| | (9.099) | | |
| *TAXM*[c] | N.A. | −0.022 | N.A. |
| | | (5.040) | |
| Constant[a] | N.A. | N.A. | 2.925 |
| | | | (4.259) |
| Age dummy[a] | N.A. | N.A. | −1.231 |
| | | | (3.686) |
| Dividends[a] | N.A. | N.A. | 0.512 |
| | | | (4.157) |
| Dividends$^2$ [a] | N.A. | N.A. | 3.865 ($10^{-4}$) |
| | | | 0.550 |
| Adjusted gross income[a, d] | N.A. | N.A. | 0.009 |
| | | | (1.184) |
| Adjusted gross income$^2$ [a, d] | N.A. | N.A. | 8.561 ($10^{-7}$) |
| | | | (1.470) |
| *TAXM*[a, c] | N.A. | N.A. | −0.525 |
| | | | 8.284 |
| *TAXM*$^2$ [a, c] | N.A. | N.A. | 0.029 |
| | | | (12.664) |
| *TAXM* times dividends[a, c] | N.A. | N.A. | −0.016 |
| | | | (2.352) |
| *TAXM* times *AGI*[a, c] | N.A. | N.A. | −0.005 |
| | | | (14.452) |
| *Summary Statistics:* | | | |
| Corrected $R^2$ | 0.003 | 0.004 | 0.017 |
| Corrected standard error | 5.100 | 5.099 | 5.065 |
| Elasticity at point of means | −1.77 | −1.01 | −0.44 |
| Elasticity for \$3,000 ≤ dividends < \$10,000 | −1.49 | −0.85 | −0.21 |
| Elasticity for \$10,000 ≤ dividends < \$20,000 | −2.50 | −1.44 | −0.31 |

TABLE II (*continued*)

| Independent variables | Dependent variables: long-term stock gains[a] (equation numbers) (1) | (2) | (3) |
|---|---|---|---|
| Elasticity for $20,000 ≤ dividends < $50,000 | −2.54 | −1.48 | −0.42 |
| Elasticity for dividends ≥ $50,000 | −3.03 | −1.79 | −1.49 |

*Sources*. Internal Revenue Service 1973 Capital Assets File.
a. Divided by dividends.
b. *AGI* net of actual long-term and short-term stock gains plus predicted long-term and short-term gains.
c. Tax rates in regression expressed as an integer number of percentage points.
d. *AGI* net of actual long-term stock gains.
N.A. = Not applied.
*t*-statistics in parentheses.

(presented as equation (1) in the same table).[6] The results of the two equations are different in some respects due to differences between the data files used by FSY and myself. FSY used the Internal Revenue Service's first version of the data file; my file is a second version, with some errors corrected. While my estimated elasticity of capital gains realizations to tax rates is numerically smaller (in absolute value) than that of FSY at −15.53, both estimates can be fairly described as astronomical, and the differences between the data files are probably sufficient to explain the modest shrinkage.

In equation (3) of Table I, the tax rate variable is changed to a preferred formulation that is computed directly rather than through the instrumental variables technique. This direct formulation, like the instrumental variables approach, avoids simultaneity between an individual taxpayer's marginal tax rate and the amount of gains he realizes; but unlike the instrumental variables approach, it circumvents some potential measurement problems due to current

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[6] The first-stage equation is (*t*-statistics in parentheses):

$$\begin{aligned} TAXFSY = {} & \underset{(10.221)}{8.566} + \underset{(3.835)}{0.494}\ \text{Age Dummy} \\ & - \underset{(3.709)}{0.121}\log(AGI) + \underset{(5.011)}{0.210}\log(\text{Dividends}) \\ & + \underset{(157.659)}{0.687}\,TAXF - \underset{(3.305)}{0.004}\,TAXL \\ \bar{R}^2 = {} & 0.460;\ C.S.E.E. = 10.270, \end{aligned}$$

where *TAXF* is the actual first dollar tax rate and *TAXL* is the last dollar tax rate based on a predicted amount of gain.

transactions in assets other than corporate stock, or to loss carryovers.[7] Changing from the FSY technique to the preferred formulation of the tax variable reduces the absolute value of the tax rate coefficient very slightly, with the measured elasticity also modestly lower at −11.35.

The specification of the original FSY equation and the present equations (2) and (3) is quite restrictive. A more general formulation would allow for interactions among the tax, dividend, and *AGI* variables, and would allow for a nonlinear tax response. Equation (4) in Table I so generalizes the relationship.[8] As can be seen from Table I, this preferred generalization of the specification raises the estimated elasticity to −16.83 when using ordinary least squares estimation. Thus, all of the preferred changes in the FSY specification cause minimal reductions or increases in the absolute value of the FSY elasticity when estimation is done by ordinary least squares.

Table II duplicates Table I with the sole exception that weighted least squares estimation is used. The results are substantially changed in all of the alternative specifications. The FSY formulation yields an average elasticity of −1.77, about one-ninth of my estimate using the same formulation with ordinary least squares, and about one-thirteenth of the FSY published result (computed with weighted summary statistics rather than the unweighted statistics presented by FSY).[9] The range of estimated elasticities extends from −1.49 in the smallest portfolio class to −3.03 for those with at least $50,000 of dividends. Shifting to the preferred tax rate variable in equation (2) reduces the elasticity to an average of −1.01,

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[7] See Appendix II.

[8] All variables in equation (4), rather than only the dependent variable as in equations (1) through (3), are divided by dividends; thus the constant term becomes 1/Dividends, the Dividends term becomes a constant, and Dividends$^2$ becomes Dividends. This normalization on both sides of the equation is a correction for heteroskedasticity. Absent the normalization, the estimated tax rate elasticities in the unbiased weighted version increase with portfolio size until for those with the largest portfolios they are counterintuitively positive.

[9] The first stage equation is (*t*-statistics in parentheses):

$$\begin{aligned} TAXFSY = {} & \underset{(11.263)}{-4.836} - \underset{(8.151)}{0.481}\text{ Age Dummy} \\ & + \underset{(10.994)}{0.119}\log(AGI) + \underset{(14.748)}{0.567}\log(\text{Dividends}) \\ & + \underset{(237.147)}{0.823}TAXF - \underset{(1.493)}{0.001}TAXL \end{aligned}$$

$$\bar{R}^2 = 0.699;\ C.S.E.E. = 4.990,$$

where *TAXF* is the actual first dollar tax rate and *TAXL* is the last dollar tax rate based on a predicted amount of gain.

with a range of −0.85 for the smallest portfolio class to −1.79 for the largest. The preferred specification is equation (3), which includes the nonlinearities and the interaction terms. In that equation the estimated average elasticity is −0.44, with a range from −0.21 (for those with $3,000 to $10,000 of dividends) to −1.49 (for those with over $50,000 of dividends).

The results from the preferred equation contrast sharply with those of FSY. The effect of dividends (as a proxy for portfolio size and net of the interaction with tax rates) on realizations is positive, as is that of income.[10] Both coefficients indicate that wealth and financial sophistication are associated with more frequent trading. The dummy variable for elderly taxpayers has a negative sign, indicating that the death escape from capital gains taxation overrides the need for cash among those at least 65 years old who own at least $100,000 worth of corporate stock.[11] All of these results are more plausible a priori than those of FSY. Unlike the FSY elasticity of −22.57, the average estimate here is plausible, and the pattern logically suggests that those with the largest potential tax liabilities are most sensitive to tax rates.[12]

Clearly, the much smaller estimated elasticity would have a drastic effect on any simulation of a change in the tax code regarding capital gains. Table III shows the effect (at 1973 income levels) of introducing the capital gains tax reductions in the Revenue Act of 1978.[13] The results show that the reductions in capital gains tax rates

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[10] *AGI* is measured net of stock gains. Inclusion of actual stock gains in the income variable would result in multicollinearity with any tax rate on gains. Inclusion of an average amount of stock gains, as in FSY, imparts a negative bias to the coefficient, because such a variable underestimates true *AGI* for high-gain returns and overestimates it for those with low gains. Omission of the insignificant squared term does not change the results.

[11] FSY argue that the elderly are more likely to sell stock to satisfy their need for cash, but are less likely to realize gains because the basis of their shares will be revalued at death and the capital gains tax avoided. This would suggest that FSY might obtain a negative coefficient for the dummy in the gains equation, but not in the sales equation (entirely consistent if the elderly with diversified portfolios, as most with at least $100,000 of stock probably have, follow the age-old, or perhaps old age, adage of "realize your losses and let your gains run"). In fact, FSY get precisely the opposite signs (though the gains equation coefficient is insignificant), suggesting again that their results are suspect. The dummy coefficients in Table II, in contrast, are plausible a priori.

[12] An expanded model, partially accounting for the transitory fluctuations in marginal tax rates on capital gains, suggests that a longer run elasticity might be somewhat smaller (in absolute value) for the most tax sensitive larger portfolio groups, with an overall average of about −0.79 [Minarik, 1981].

[13] The Revenue Act provisions include the reduction of the portion of long-term gains included in adjusted gross income from 50 to 40 percent, the abolition of the alternative tax, and the removal of the excluded portion of long-term gains from tax preferences in the minimum tax and the maximum tax.

TABLE III

CHANGES IN TAX LIABILITY RESULTING FROM THE CAPITAL GAINS TAX REDUCTIONS OF THE REVENUE ACT OF 1978, 1973 INCOME LEVELS

| Adjusted gross income (dollars) | Number of returns[a] (thousands) | 1973 tax liability (millions of dollars) | Tax liability under 1978 act (millions of dollars) | Change in tax liability (millions of dollars) | Change in tax liability (percent) | Change in tax liability (dollars per return) |
|---|---|---|---|---|---|---|
| Less than 0 | 15.1 | 11.6 | 1.9 | −9.7 | −83.9 | −645.4 |
| 0–2,500 | 83.3 | 0.3 | 0.0 | −0.3 | −98.0 | −3.6 |
| 2,500–5,000 | 98.8 | 9.5 | 8.6 | −0.9 | −9.1 | −8.8 |
| 5,000–7,500 | 106.3 | 33.6 | 30.8 | −2.8 | −8.4 | −26.5 |
| 7,500–10,000 | 119.8 | 85.1 | 83.7 | −1.4 | −1.7 | −12.0 |
| 10,000–15,000 | 244.7 | 324.0 | 317.4 | −6.6 | −2.0 | −27.1 |
| 15,000–20,000 | 310.6 | 666.6 | 652.4 | −14.3 | −2.1 | −46.0 |
| 20,000–25,000 | 245.0 | 726.4 | 708.2 | −18.1 | −2.5 | −74.0 |
| 25,000–30,000 | 171.4 | 666.6 | 657.6 | −9.0 | −1.4 | −52.6 |
| 30,000–50,000 | 329.3 | 2,316.9 | 2,241.8 | −75.2 | −3.2 | −228.2 |
| 50,000–100,000 | 171.6 | 2,748.6 | 2,647.2 | −101.5 | −3.7 | −591.5 |
| 100,000–200,000 | 48.0 | 1,964.6 | 1,843.8 | −120.8 | −6.1 | −2,518.8 |
| 200,000–500,000 | 11.6 | 1,239.7 | 1,101.5 | −138.2 | −11.1 | −11,880.3 |
| 500,000–1,000,000 | 1.7 | 495.1 | 413.6 | −81.5 | −16.5 | −48,030.0 |
| 1,000,000 and over | 0.6 | 546.2 | 434.6 | −111.6 | −20.4 | −181,501.1 |
| Total or average | 1,957.6 | 11,834.9 | 11,143.0 | −691.9 | −5.8 | −353.4 |

*Sources.* Internal Revenue Service 1973 Sales of Capital Assets File and Individual Tax Model File.

a. With dividends of at least $3,000.

would reduce tax revenues by approximately $700 million, and that the amount of tax reduction would increase in both absolute and percentage terms as income increases.

## CONCLUSION

Because of a statistical problem, the estimate by Feldstein, Slemrod, and Yitzhaki of the revenue effect of changes in capital gains tax rates is wide of the mark. The 1973 Capital Assets File data indicate that reductions in capital gains tax rates do not generate enough additional realizations to offset the static revenue loss. Further, if the amount of realizations of gains is an indicator of efficient reallocation of financial resources, the efficiency gains of such tax cuts will be far lower than FSY indicated.

In the more than three years since this comment was originally submitted, several rounds of data on post-1978 capital gains realizations have been released. These data have been cited by several analysts to argue that the 1978 capital gains tax cut was or was not self-financing. It might be helpful to conclude this comment with an analysis of the recent data as they pertain to this question. There are no data specifically on corporate stock sales, however, and so the discussion must be generalized to all capital gains.

The increase in the capital gains exclusion from 50 to 60 percent became effective on November 1, 1978, reducing the highest tax rate on capital gains from 49.125 percent to 34.9 percent. Excluded capital gains were dropped from the base of the minimum tax and the offset against the preferential maximum tax rate, but only as of January 1, 1979. This further reduced the highest rate on capital gains to 28 percent, and probably led to the postponement of realization of some gains from 1978 to 1979. The excess of net long-term capital gains over net short-term capital losses realized by the same taxpayers (that is, the amount of long-term capital gain, before the exclusion, that is subject to federal income tax) increased from $48.6 billion in 1978 to $70.5 billion in 1979. Using the 1978 figure as a base (a step that is discussed below) and taking the tax cut to be 20 percent (the percentage decrease in the included portion; in fact the tax cut was greater for taxpayers subject to the minimum or maximum taxes, and less for those who lost the 25 percent alternative tax on the first $50,000 of gain) implies an elasticity of −2.25. This is somewhat greater in absolute value than the −0.44 estimated here, but substantially less than FSY's −22.57.

Several factors suggest that this roughly calculated elasticity of

−2.25 somewhat exaggerates the actual experience. The first is the inclusion in 1979 realizations of a single sale—the Belridge oil merger—on which the price of a 56 percent family-owned firm was $3.65 billion. Such a realization is clearly unlikely to be repeated, though it was almost certainly encouraged by the capital gains tax cut. The second is the likely postponement of some gains from 1978 to 1979 due to the nature of the law, thus reducing the base and increasing the observed effect. The third is the use of the 20 percent tax cut for the rough calculation, though it was in fact somewhat larger for some taxpayers (the minimum and maximum tax effects likely outweigh the alternative tax repeal).

A fourth factor that must be considered is the counterfactual question. The proper comparison for 1979 realizations is not really with those for 1978, but rather those that would have occurred in 1979 in the absence of the tax cut. Realized capital gains have increased even in periods with no favorable tax changes, driven by increases in corporate dividends and fixed investment, aggregate real economic growth, mere inflation, and any number of other factors. The general price level increased by 8.6 percent in 1979 (using the gross national product deflator), and prices on the New York Stock Exchange rose at the same rate (measured by the NYSE composite index); both of these factors would independently increase realizations. It would be misleading to assign causally all of the increase in realizations in 1979 to the tax cut, with no allowance for these independent forces.

A final factor is the temporary, as opposed to continuing, unlocking effect of the 1978 tax cut. Economic theory predicts that those owners of appreciated assets who were on the margin of realizing their gains under the prior law would decide to sell after a tax cut.[14] The issue in this discussion, however, is how much realizations would be increased after this transient rush of asset sales. A fair interpretation of FSY's results would be that the 1978 tax cuts would approximately triple the level of realizations that would have occurred without the tax cut in every later year, and that there would be an additional temporary increase in realizations for one or perhaps several years following the cut.[15] Thus, again, the 1979 data are not indicative of the long-term effect on realizations and tax revenues; they must be discounted for the transient unlocking predicted by economic theory before any permanent unlocking effect can be measured.

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[14] See Minarik [1981], footnote 28, page 256, and its references.

[15] This interpretation is Feldstein's: "I think the right way to interpret these estimates is not as a short-run unlocking, but as a permanent unlocking. After all, what we are studying is differences among taxpayers that continue from year to year. I think what we are estimating here is that there would continually be more turnover in the market, more realizing of gains, and less postponement than there is today. I think this is probably a slight overestimate of the permanent extra revenue that would be produced but a substantial underestimate of the immediate effect of unlocking" [1978, p. 334].

The 1980 income tax data confirm that the long-term effect of the tax cut is in fact smaller than the 1979 figures would suggest. Net long-term gains in excess of net short-term losses in 1980 were $69.9 billion, down from the 1979 level, even though the stock market was strong in 1980 (which almost invariably causes realizations to go up, the sole exception in recent years being 1980), and inflation proceeded at 9.3 percent. Thus, it seems likely that the sharp increase in realizations in 1979 was in large part the result of the temporary unlocking effect, and that realizations and tax revenues will be lower in later years than the 1979 data suggest. The effect of the tax cut was more in line with the estimates presented here, and the FSY estimates, by the same token, appear even more unreasonable.

To demonstrate this, discard the 1979 data because of the purely temporary effects and compare the 1980 data directly with 1978. Assuming as a very rough first approximation that realizations in any event would have kept up with inflation, the remainder of the realization growth that can be assigned to the capital gains tax cut implies an elasticity of −1.05, not the −2.25 apparent from the 1979 data. Alternatively, it could be assumed that capital gains realizations would have increased at the same rate as corporate stock prices (in every year save two in which stock prices have increased since 1960, realized capital gains have increased faster; one of the exceptions is 1980). Using this standard, the remaining increase in realizations to be explained by the 1978 tax cut yields an elasticity of −0.67. Any discounting of these elasticities for the excess of the actual tax cut over the 20 percent assumed in the calculation and the understatement of the 1978 base due to tax incentives for postponement of realizations to 1979 would push them still closer to the estimate in this Comment.

The 1980 data, unfortunately, mark the end of our experiment with the 1978 tax cut. Effective June 9, 1981 (as determined by the conference committee on the Economic Recovery Tax Act of 1981 on August 1 of that year), the maximum tax rate on long-term capital gains was further reduced from 28 to 20 percent. After this tax cut of almost 29 percent for the highest income taxpayers, and with the NYSE index up 8.7 percent and the GNP deflator increasing by 9.4 percent in 1981, the final IRS figures show net long-term capital gain in excess of net short-term capital loss increasing to only $77.1

billion, up just 10.3 percent from 1980 and 3.3 percent from 1979. Assuming that realizations would just have kept pace with prices since 1978 and completely ignoring the 1981 tax cut implies an elasticity of realizations to tax rates of −1.10; assuming that realizations would have increased along with the stock market yields an elasticity of −0.72.[16] Any realizations stimulated by the 1981 tax cut would make these figures overestimates of the true effect of the 1978 cut. Thus, it seems even clearer that the 1979 increase in realizations was largely caused by the temporary unlocking, and that the remaining permanent effect of the tax cut is far smaller than claimed by FSY.

## APPENDIX I

Hausman and Wise [1981] algebraically derive the bias and show that weighted least squares yields consistent estimates as follows. (In fairness, it should be noted that the Hausman and Wise analysis of this problem was published after FSY.)

Consider the two-variable example in Figure II where the amount of the gain ($Y$) is a function of the tax rate ($X$). Assume that for the population the density function $f(Y|X)$ is normally distributed around mean $X\beta$ with variance of $\sigma^2$. For the sample and because of the stratified sampling (for simplicity, by two classes), $f(Y|X)$ will be an irregular function that can be described by the density function,

$$h(y) = \begin{cases} \dfrac{P_1 \cdot f(y)}{P_1 \cdot Pr\,[Y \le L] + P_2 \cdot Pr\,[Y > L]}, & \text{if } y \le L \\[2ex] \dfrac{P_2 \cdot f(y)}{P_1 \cdot Pr\,[Y \le L] + P_2 \cdot Pr\,[Y > L]}, & \text{if } y > L, \end{cases}$$

where $P_1$ and $P_2$ are the sampling rates for the two sampling stratification classes, $Pr$ indicates probability, and $f(y)$ is the normal density function $N(X\beta,\sigma^2)$. Dividing through by $P_1$, so that $P_2/P_1 = P$, one can state this density function as

$$h(y) = \begin{cases} \dfrac{f(y)}{\int_{-\infty}^{L} f(y)\,dy + P \cdot \int_{L}^{\infty} f(y)\,dy}, & \text{if } y \le L \\[2ex] \dfrac{P \cdot f(y)}{\int_{-\infty}^{L} f(y)\,dy + P \cdot \int_{L}^{\infty} f(y)\,dy}, & \text{if } y > L. \end{cases}$$

Integrating over this density function yields

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[16] This estimate is virtually identical to my alternative [Minarik, 1981] cited in footnote 12 above.

$$E(Y|X) = X\beta - \sigma \frac{(1-P)\phi[(L_i - X_i\beta)/\sigma]}{(1-P)\Phi[(L_i - X_i\beta)/\sigma] + P},$$

where $\phi$ is the normal density function and $\Phi$ is the normal distribution function. Not surprisingly, given that ordinary least squares gives estimates for the sample rather than the population, the parameter $\beta$ is measured with bias. Note that under random sampling (that is, $P_1 = P_2$ so that $P = 1$) the bias term becomes 0, so ordinary least squares is unbiased. Note also that if stratification in the example were by tax rates rather than capital gains, $E(Y|X)$ would be unaffected, and OLS would yield unbiased estimates. Measuring the parameter $\beta$ for the population rather than the sample would require minimizing

$$S = \sum_{i=1}^{N} \left(\frac{1}{P_i}\right)(Yi - X_i\beta)^2,$$

where $P_i$ is the relevant sample rate for the *i*th observation. This is the formulation of weighted least squares, which yields unbiased estimates. However, the standard errors of coefficients as usually computed are incorrect; computation of correct standard errors is extremely complex and is not attempted in this paper.

## APPENDIX II

The choice of a tax rate variable that is representative of the marginal rate at which taxpayers made their realization decisions, yet not simultaneous with the amount of gains realized, is difficult. Actual last dollar tax rates are simultaneous and thus cannot be used. FSY use an instrumental variables technique wherein the first-stage equation predicts the last dollar tax rate on long-term gains, with the first dollar capital gains tax rate and a predicted last dollar capital gains tax rate (based on average capital gains of returns with approximately the same *AGI* and dividends) as instruments. This choice of instruments is inappropriate for two reasons. First, the last dollar tax rate is the relevant cost for the investor's decision whether or not to realize additional gains; it is not the cost of realizing the gains he in fact did realize. While the last dollar tax rate is thus typically too high, the first dollar tax rate is analogously typically too low. Second, all three tax rates in FSY's first-stage equation are actually computed on marginal amounts of gains equal to $100, and thus can be strongly misleading if there are small amounts of carryover or other capital losses present. For example, the tax on the first $100 of stock gain for a return with $1,100 of short-term loss carryover is zero; however, if the carryover were only $1,000, the gain would be taxed at the ordinary rate that could be as high as 70 percent. Neither of these measures is an accurate tax rate for a more reasonable amount of gain. Of the tax returns in the file with dividends of at least $50,000, 26.7 percent (weighted; 29.0 unweighted) had zero first dollar tax rates, and 24.3 percent (weighted; 23.4 percent unweighted) had zero last dollar tax rates.

This is in marked contrast to the 8.3 percent (weighted; 11.2 percent unweighted) who had zero marginal tax rates on ordinary income. Another potential pitfall, though less serious, would be a small increment of gain falling within the 25 percent alternative tax on the first $50,000 of gain that was in the law in 1973.

The variable used here is the effective rate on a predicted amount of stock gain (the average stock gain of all returns with similar amounts of dividends and adjusted gross income). This formulation avoids the simultaneity of actual realizations with the tax rate because the predicted amount of gain on which the tax rate is calculated is not directly related to the taxpayer's actual gains (see FSY [1980], p. 780). It also minimizes the distortion of the tax rate due to small amounts of carryover or losses, because the predicted gain is large enough to swamp typical amounts of loss or carryover. Thus, only 11.8 percent (weighted; 11.5 percent unweighted) of the tax returns with dividends of at least $50,000 had zero tax rates by this measure. Finally, because the predicted amount of gain is typical of similar tax returns, the effective tax rate on that amount of gain is more representative of the tax rate at which marginal decisions were actually made in 1973 (see FSY [1980], p. 781).

CONGRESSIONAL BUDGET OFFICE

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Senator BAUCUS. Our next panel will be Mr. Phillip Chisholm, Executive Vice President of the Petroleum Marketers Association; Mr. Charles DiBona, President of the American Petroleum Institute; Mr. Joseph Ackell, Senior Vice President and Chief Legal Officer, Northville Industries Corporation, testifying on behalf of The Independent Fuel Terminal Operators Association; and Mr. Richard Barnett, Chairman of the Alliance for Responsible CFC Policy.

Gentlemen, we are happy to have you here, and thank you for being so patient, after waiting for the preceding panels. Mr. Chisholm, why don't you begin?

## STATEMENT OF PHILLIP R. CHISHOLM, EXECUTIVE VICE PRESIDENT, PETROLEUM MARKETERS ASSOCIATION OF AMERICA, WASHINGTON, DC

Mr. CHISHOLM. All right. Thank you, Mr. Chairman. My name is Phillip R. Chisholm. I am the Executive Vice President of the Petroleum Marketers Association of America, PMAA.

PMAA is the largest national representative of independent petroleum marketers in the country. Through the 41 State and regional associations that belong to PMAA, there are some 11,000 marketers who sell roughly half the gasoline, 60 percent of the diesel fuel, and three-quarters of the home heating oil that is consumed in America today.

We very much appreciate the opportunity to appear before this committee.

There are three essential points I would like to hit on out of the prepared testimony that has been submitted for the record and just try to summarize this morning.

The first one is that we recommend that when considering sources of new revenue, this committee look first to collecting the taxes that are now owed but are not being paid.

In the energy industry, for example, we have had extensive experience with the problem of excise tax evasion on both gasoline and diesel fuel. In 1986, Congress addressed the gasoline question by changing the collection procedure; and it was estimated that proposal will raise $1 billion over the next 4 years.

That proposal is not scheduled to take effect until January 1, 1988, and our testimony recommends some minor modifications to that, but basically, we are satisfied with that method of taxation or collection of the tax.

Diesel fuel is another matter. In the Joint Committee package, it is recommended that the diesel collection process be raised from the retail level where it is now to the distribution level. We certainly support that change; and, depending on which set of Government estimates you adhere to, that will raise anywhere from $100 million to $500 million a year.

We recognize that when redefining the collection point, some special consideration be given to large trucks who often play the eunuch role in the collection on tax paid diesel fuel.

But however you change the procedure, I think there needs to be some recognition that, unless there is much stronger enforcement by the IRS in both areas, evasion will continue to occur.

And we think it would be money well spent to increase the enforcement budget of IRS in this area, and I think the return would be well worth the expenditure there.

The second area of increased revenue we would recommend examination of would be the elimination of tax subsidies that have outlived their usefulness. And specifically in our testimony, we recommend the elimination of the credit—6 percent a gallon credit—and the 6 cents a gallon excise tax exemption granted gasohol.

We feet that that is a subsidy that is very, very expensive to the Federal Government and that, if it is eliminated over the next 3 years, it could raise $1.5 to $1.7 billion.

If new taxes are needed after those new sources of revenue are captured, we recommend that there be broad base taxes applicable to the population in general and not zeroing in on any single industry or any single group of individuals or companies.

The second major point we would like to make that leads into that is to stress our opposition to any new energy taxes and specifically oil import taxes or gasoline excise tax increases.

Energy is not a luxury; it is an economic necessity. It drives the economy, and higher energy prices will have ripple effects through the entire economy, increasing unemployment and lowering gross national product.

It will hit hardest those least able to pay because most energy taxes are basically regressive and regionally discriminatory.

And we also oppose energy taxes because they tend to discriminate unfairly against certain regions of the country.

The final major point I would like to hit on this morning is that in examining new revenue sources, whether they be new taxes or the collecting of taxes owned or in eliminating subsidies, other public policy considerations of those actions be carefully considered.

For example, there is a proposal in the Joint Committee on Taxation pamphlet which recommends changing the gasoline excise tax collection procedure to the refinery gate.

If that were done, it will not reduce the excise tax evasion, beyond what was done in last year's Tax Reform Bill. It will give some competitors in the marketplace a competitive advantage over others. It will be a further disincentive for primary and secondary storage of gasoline in this country and will impact most greatly those areas furthest away from the domestic refining centers of this country.

It would increase gasoline imports into the country and it will lead to higher consumer prices. Clearly, the public policy consequences of taking the excise tax collection to the refinery gate far outweigh the minimum revenue that would be collected in that procedure.

In summary, Mr. Chairman, we hope that the primary source of new income will be the collection of taxes owed and the elimination of subsidies. We again oppose all new energy taxes, and we would urge that in all revenue considerations, the other public policy considerations of your action be carefully considered. Thank you very much.

Senator BAUCUS. Thank you. Mr. DiBona.

[The prepared statement of Mr. Chisholm follows:]

## THE PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Good morning Mr. Chairman and members of the committee. My name is Phillip R. Chisholm and I am the Executive Vice President of the Petroleum Marketers Association of America. PMAA, through its 41 state and regional member associations (see Attachment I), is the largest representative of independent gasoline and home heating oil marketers in the country. Nearly 11,000 independent marketers are represented by PMAA in Washington.

I suspect I could rattle off the names of a few member companies in each of your states and you would recognize them as outstanding small businessmen in their local communities. Aside from their business interests, however, I suspect you would also recognize them as being active in civic, social and political activities within the community.

This local image of the independent marketer should not belie his or her importance to the petroleum distribution network in this country. The 11,000 small business independent marketers represented by PMAA sell more than half the gasoline, 60 percent of the diesel fuel, and three quarters of the home heating oil consumed in America today.

We are pleased to have the opportunity to appear before this committee today to present our views on various revenue options to meet the targeted revenue levels required by House Concurrent Resolution 93, the Concurrent Resolution on the budget for fiscal year 1988. Before examining specific revenue options, PMAA would first like to briefly offer an overview on its perspective of deficit reduction in general. It would also like to offer its concern about legislating tax policy based on revenue estimates. Then specific revenue options PMAA opposes will be discussed, after which revenue options which merit support will be detailed. In discussing revenue options, either from a positive or negative perspective, PMAA will focus exclusively on areas related to the petroleum industry and not address general tax issues. These general tax issues have been and will continue to be addressed by other witnesses before this committee.

### Overview on Reducing Federal Budget Deficits

As small businessmen, independent marketers are very supportive of efforts to reduce the federal budget deficits. They recognize the negative consequences such deficits have on the general economy and thus on their businesses.

In determining how the massive federal deficits currently being faced should be reduced, independent marketers believe the first step is to reduce federal spending and to eliminate waste in our federal budget. This is very similar to the philosophy applied to the energy industry during the 1970's that a barrel of oil saved through conservation is a barrel of oil that could be used in the future. Likewise, a dollar in reduced spending in the federal budget is a dollar not raised through increased taxes. We believe additional reductions in federal spending are possible, but we understand that is not the subject of debate at this hearing.

After federal spending is reduced by the greatest extent possible and additional revenue is still needed, PMAA recommends that a concerted effort be made to enforce all existing tax laws to ensure that revenues the government is currently entitled to are, in fact, being collected. As will be evidenced later by our testimony on motor fuel excise tax collections, much more can be done in this area.

Once federal spending has been reduced, all taxes owed are being collected and additional revenue is still needed, PMAA believes such new taxes should apply as broadly as possible, affecting everyone equally. Such new taxes should not be regressive; they should not discriminate regionally; they should not give one competing industry a competitive advantage over another, nor should they give particular competitors in the same industry a competitive advantage over others.

This test is a heavy burden for any new tax to meet, but we believe it is one which is absolutely necessary in order to restore fairness, equity and confidence in the federal tax system.

## Tax Policy Through Revenue Enhancement

One disturbing trend that concerns PMAA greatly is Congress' willingness to make major changes in tax policies without fully assessing other public policy consequences of its action. It seems that Congress is so preoccupied with raising new revenue that if a proposal raises a few dollars, it's damn the other policy consequences, full speed ahead with new revenue. This "price tag" tax policy philosophy not only has disastrous consequences for affected industries, but also has long-run negative consequences for the entire country.

PMAA can speak first hand to this issue. During the early part of 1986 there was much concern over gasoline excise tax evasion. While there was some difference of opinion over the true extent of the evasion, all parties - the Administration, the Congress, and the industry - agreed the problem must be addressed and were willing to cooperate on ways to stop evasion whereever it occurred. The Administration's and the Congress' interest in this issue were pretty clear. For the industry the desire to stop evasion was equally compelling. If a particular competitor had a nine cents per gallon price advantage over someone else by virtue of not paying the federal excise tax, then that particular individual could destroy the profitability of other competitors, thus driving them out of that market and in the case of independent marketers, out of business.

In fact, the industry was so concerned about the problem of excise tax evasion that it brought it to the attention of government officials long before a strong concern was being expressed by anyone else.

The process of the Administration, the Congress and the industry trying to find a solution which ended evasion but which did not create distortions within the industry had been underway for only a few months when suddenly a price tag of $1 billion over four years was attached to a proposed change in the excise tax collection process that was adopted by conferees on the massive Tax Reform Act of 1986 (P.L. 99-514).

The new collection procedure was not in either the House or Senate tax bill and had not been subject to any public hearings. It took away the right of wholesale distributors to remit the tax to the federal government, a right expressly given by the Congress in the late 1950's because Congress recognized the competitive problems presented by requiring the wholesale distributor to pay the tax directly to its supplier. This re-created the same enormous problems for independent marketers that Congress had tried to correct in 1958.

Apparently, these problems were not considered once a revenue price tag had been attached to the proposal.

The only consolation to marketers in the whole process was that the change did not take effect until January 1, 1988. This was small consolation to one marketer who noted: "It's nice to have a year's notice before someone takes a considerable slice out of your business."

Let me reiterate that PMAA is firmly committed to supporting efforts to eliminate excise tax evasion on not only gasoline but diesel fuel as well. We believe, however, that can be accomplished in a way that makes marketers part of the solution rather than the prime source of the problem. Later in this testimony is a specific proposal by PMAA which will allow marketers to be part of the total motor fuels collection process and which increases revenue to the federal government.

## Revenue Options PMAA Opposes

Below are a series of revenue options that PMAA specifically opposes as a means of generating the additional revenue mandated by House Concurrent Resolution 93. Most of these relate to direct new taxes on energy. PMAA does not believe that the energy industry can bear the brunt of additional taxes in light of the devastating impact that falling oil prices had on the entire energy industry in 1986. Moreover, we do not believe that consumers who saw their energy conservation efforts finally pay off in 1986 with the fall in oil prices should now be penalized for those conservation efforts by the imposition of new taxes which more than make up the recent price declines.

Energy is not a luxury. New taxes on energy can not be described as "sin taxes". Energy is an economic necessity. It drives our economy; fuels our homes; and transports our people and our goods nationwide. New energy taxes are inappropriate ways to raise new revenue and the only manner which PMAA could consider supporting new energy taxes is as part of a broad based tax hitting all industries equally.

Now PMAA will address specific energy tax proposals.

Oil Import Taxes:

PMAA opposes oil import taxes for several reasons. First, oil import taxes are inefficient ways of raising new revenue. A study by Exxon estimates that an $8 per barrel tax would generate $60 billion in higher energy costs for consumers. Only approximately one quarter of that amount or, $15 billion, would find its way into the federal treasury.

Secondly, such a tax is regionally discriminatory. It would affect disproportionately the northeastern section of our country where millions of homes are heated by home heating oil. This is, of course, unfair not only to those millions of consumers, but also to the thousands of home heating oil dealers who have offered fast, high quality, dependable home heating service to consumers for decades.

The third reason for opposing oil import taxes is that they will create competitive imbalances in the petroleum industry. These imbalances result from the fact that some refiners have greater access to lower cost, untaxed domestic crude oil than other refiners which have a greater dependency on higher cost imports.

Our fourth concern relates to ways in which the last two concerns might be handled. Government's track record in dealing with competitive imbalances resulting from different crude oil prices has been to create an entitlement program whereby refiners with access to lower cost crude oil pay entitlements to refiners dependent on higher cost crude. The government proved conclusively in the 1970's its inability to effectively regulate the oil industry. An oil import fee would invite direct government involvement back into the industry. Such involvement would only lead to greater industry problems and higher consumer prices as our 1970's experience clearly demonstrated.

Moreover, some have suggested that home heating oil might be exempted from any oil import tax. Since heating oil is a refined product derived from a barrel of crude oil, there is virtually no way to exempt it without in fact regulating its price and the price of other petroleum products as well.

Fifth, oil import taxes have a strong negative impact on the general economy. They lead to lower GNP, higher inflation, and higher unemployment. They also place domestic manufacturers at a competitive disadvantage with foreign manufacturers. These negative economic impacts result in greater government outlays for social programs and unemployment benefits.

Sixth, oil import taxes, while perhaps benefitting some banks with high domestic energy loan portfolios, will seriously hurt other banks that have loans to foreign countries including Mexico and Venezuela from which we now import considerable amounts of oil. Suggestions that these countries be exempt from such a tax are naive and fail to recognize that such exemptions would be counterproductive to the overall goals of the tax and would increase the level of federal involvement in the administration of the tax.

Seventh, an oil import tax violates the General Agreement on Tariffs and Trade (GATT). Already, the U.S. has been found in violation of the GATT treaty for enacting a small tax differential between imported and domestic oil as part of last year's Superfund legislation. PMAA would recommend that differential be deleted and for the U.S. to maintain full compliance with its GATT obligations.

Eighth, PMAA believes that while import taxes may stimulate increased domestic oil production, it will not stimulate increased exploration. Exploration incentives are needed, but an import tax that can be offered and taken away at the whim of Congress is not an appropriate incentive.

In summary, PMAA opposes oil import taxes because we believe they are inefficient means of raising federal revenue; they are bad for the economy; and, they represent unsound energy and foreign policy. We recommend they not be adopted as a revenue option. We recommend further that should an import tax be adopted over these objections, it should be applied equally to crude oil and all petroleum products. Providing a higher tariff on petroleum products would be little more than an unneeded subsidy to the domestic refining industry which lessens competition in the entire marketing segment.

Motor Fuel Excise Tax Increases:

PMAA opposes increases in the federal excise tax on gasoline and diesel fuel for many of the same reasons it opposes oil import taxes. Motor fuel excise taxes are regressive, impacting severely on lower income persons less able to pay higher taxes. As a percentage of income by class in 1985 families with incomes of less than $5,000 paid 1.62 percent of their income for gasoline excise taxes as opposed to families making over $50,000 which pay only 0.22 percent of their income. This means families earning less than $5,000 pay 7 times as much of their income for gasoline excise taxes as do families making over $50,000.

Motor fuel excise taxes are regionally discriminatory. They impact most greatly on rural states with little or no mass transit and individuals who must drive greater distances to get back and forth to work.

Increases in motor fuel excise taxes also have ripple effects through the entire economy. Higher gasoline and diesel fuel excise taxes mean higher transportation costs which mean higher prices for all goods and services.

The use of higher excise taxes as a means of deficit reduction also violates the basic tenet of excise taxes as a user fee which is deposited in the Highway Trust Fund to upgrade our roads and highways. Using excise tax revenue for purposes other than Highway Trust Funds is a dangerous precedent which should be avoided.

Other grounds for opposition to excise tax increases are the negative impact such taxes may have on the petroleum industry. A recent Congressional Research Service (CRS) study, Gasoline Excise Tax: Economic Impacts of an Increase, (May 13, 1987) shows that given the relative price and demand elasticity for gasoline, a 10 cent per gallon tax increase would reduce annual final sales by the industry by $9 billion. This will, of course, reduce industry profits "extending the recent decline in profitability and probably leading to the closing of more refineries and motor fuel outlets." according to the CRS. For independent marketers, specifically, an increase of 10 cents per gallon would also seriously affect the marketer's cash flow and reduce the available credit lines from his banks and suppliers.

In summary, PMAA opposes excise tax increases as a means of increasing revenue because they are regressive, regionally discriminatory, and would negatively affect the general economy. They would also set a precedent for diverting such funds from the Highway Trust Fund. Given the competitive nature of the petroleum marketplace, marketers and refiners would likely have to absorb part of the increase, thus worsening an already beleaguered oil industry.

## Other Energy Taxes:

PMAA also opposes other proposed energy taxes including the broad based tax on petroleum and the BTU tax. Many of the arguments already expressed are equally applicable to these two taxes as well. However, if forced to choose a single tax on energy to be the energy industry's contribution to reducing the federal deficit, it would be the broad based BTU tax. Such a tax would apply equally to all fuels based on BTU content. Its principal advantage is that it would not provide, through new taxes, an incentive for one source of energy over another. A tax on just petroleum, however, would give incentives to purchase other fossil fuels, thus giving these fuels a competitive advantage in the marketplace.

PMAA believes all fuels should compete on their relative economic merits and government policy should not attempt to influence consumer choice in this area.

Collection of Excise Tax at Refinery Gate:

PMAA strongly opposes the revenue option listed by the Joint Committee on Taxation (JCT) which would provide for collection of the gasoline excise tax at the refinery gate. This is a prime example of what was described earlier as "price tag" tax policy.

On the surface, the proposal looks attractive because it could raise $300 million in FY 1988 without any increase in taxes. However, other public policy considerations would weigh heavily against this idea. Consider the following:

- Since refiners would be paying the tax on gasoline at the point of manufacture, they would maintain gasoline inventories at bare bones levels and operate their refineries to meet only their immediate needs. This could lead to spot shortages of gasoline, even gasoline lines, although there is no actual shortage of crude oil or refining capacity;
- The change would encourage a shift in the manufacturing process for gasoline from refineries to terminals as suppliers send unfinished gasoline from the refinery to the terminal where it will be blended with feedstocks to finish the manufacturing process. This could give some companies a competitive advantage over others and may lead to massive excise tax evasion;
- The incentive to import gasoline will become greater as refiners, terminal operators and others seek to reduce primary inventories to avoid payment of the excise tax until the last possible point in the distribution channel;
- Thousands of independent gasoline wholesalers and retailers would have their cash flow slashed as their major suppliers try to recover their lost cash flow by reducing credit terms to these marketers. This in turn will decrease the incentive for these marketers to maintain any measurable level of secondary storage;
- Regional refiners who operate retail service stations in close proximity to their refineries will have a clear competitive advantage because they will be able to collect the tax from their customers before it is due. This competitive advantage will have ripple effects throughout all surrounding markets.

For all of these public policy reasons, PMAA opposes moving the gasoline excise tax collection to the refinery gate.

Other Oil Industry Proposals:

While PMAA represents petroleum product marketers, we are also vitally concerned about the future viability of the entire petroleum industry, particularly in light of the devastating impact that last year's price decline had on the industry. In reality, however, not just the industry was impacted. The entire country will feel the impacts if the erosion of the domestic petroleum industry is not soon halted and reversed. Therefore, PMAA cannot support any proposals designed to raise revenue which negatively impacts the production and exploration industry.

Included in the package provided by the JCT were several such proposals including the elimination of the oil and gas passive interest provisions in last year's tax bill, repeal of the existing depletion allowance, and repeal of the provision relating to intangible drilling costs.

We do, however, support the Administration's recommendation that the Windfall Profit Tax be repealed. This is viewed as being revenue neutral in the JCT pamphlet and would remove a tremendous paperwork burden from many oil producers.

## Revenue Proposals PMAA Supports

### Gasohol Tax Exemption:

PMAA strongly supports the repeal of both the ethanol tax credit and excise tax exemption provided under current law. We believe, however, the actual loss to the federal government to be much higher than that included in the JCT pamphlet.

In 1985 more than 6.5 billion gallons of gasohol was consumed. The federal tax subsidy for this consumption was more than $400 million either through the excise tax exemption or the 60 cents per gallon production credit.

Perhaps more frightening than the actual revenue loss is the growth in the use of gasohol. What was 6.5 billion gallons in 1985 began as 850 million gallons in 1981. If the same rate of growth occurs in the next three years as occurred between 1981 and 1985, the loss to the federal government over those three years will approach $1.7 billion.

This rate of growth is not unreasonable given the impact gasohol has had on the gasoline marketplace. Today gasohol is generally the lowest price unleaded fuel and marketers who sell that fuel have a competitive advantage over competitors who do not. Therefore, to remain competitive, more and more marketers are being forced to gasohol. This will increase both the demand and thus the tax loss to the federal government. PMAA does not believe federal tax subsidies should be used to give one competing fuel a price advantage over another.

The original intent of the excise tax exemption was a noble one which PMAA supported - get a fledgling industry off the ground and help the agricultural industry. It has been 10 years. The industry, if it is ever to survive, must do so without further subsidy. Independent studies have also shown this to be a costly, inefficient way of assisting farmers. A Department of Agriculture study showed it would be cheaper to provide direct subsidies to farmers than to continue these exemptions.

If this tax subsidy is eliminated the federal government would just be following a trend started by state governments. In 1986, approximately 11 states eliminated their excise tax exemptions for ethanol. Currently only 19 states still offer any form of tax subsidy.

Collection of Motor Fuels Excise Taxes:

PMAA believes significant sources of revenue still exist for the collection of federal motor fuel excise taxes. We also believe those collections can be made with independent marketers being part of the solution rather than part of the problem.

Specifically, PMAA urges that the Tax Reform Act of 1986 (P.L. 99-514) be amended in two ways. First, independent marketers who purchase product at the terminal and who meet specified financial responsibility requirements should be allowed to remit the federal excise tax to the federal government. This would correct the competitive imbalances created by the 1986 Act by allowing marketers the same terms and conditions as their refiner and terminal operator supplier/competitors. It would also allow the Treasury to collect the revenue in the same time frame as under the new law, thus resulting in no revenue loss. By maintaining the prohibition on tax exempt sales embodied in the Tax Reform Act, a relatively simple audit and enforcement trail is created. A marketer pays taxes on every gallon purchased so it is a relatively simple procedure to match up marketer excise tax remittances with sales and remittance reports which will have to be filed by refiners and terminal operators under the new law.

The Internal Revenue Service argument that they can't successfully audit 4,000 - 5,000 independent marketers who might take advantage of this proposal must be considered in light of the fact that they already must audit these same marketers for their diesel excise tax collections and remittances.

In fact, not only must they keep track of these few thousand marketers, but also tens of thousands of other marketers as well who are authorized to remit diesel fuel taxes. PMAA believes the number of diesel tax remittors is too great and would be supportive of ways to reduce that number.

One of the revenue options in the JCT pamphlet and a proposal supported by the Federal Highway Administration (FHWA) is to make mandatory an optional procedure included in last year's tax act. Under the new law, if wholesalers and retailers agreed, the wholesaler would be allowed to collect and remit the diesel fuel tax. PMAA supports the proposal making it mandatory that the marketer collect the tax from the retailer. This, in effect, reduces the number of taxpayers from approximately 100,000 to fewer than 10,000.

The JCT estimates a revenue gain of approximately $400 million over the next three years if this proposal were adopted. The Federal Highway Administration believes the revenue gain to be much higher. They estimate conservatively the income loss to be $270 million per year and believe realistically as high as $500 million per year. If the FHWA is correct, the revenue gain from this proposal would range from $800 million to $1.5 billion over the next three years.

PMAA therefore supports making independent marketers the prime focus of all motor fuels excise taxes and believes anywhere from $400 million to $1.5 billion in new revenues could flow to the Treasury in the next three years.

Stronger Internal Revenue Service Enforcement:

The truth is that no system of excise tax collection or any tax collection system for that matter will be effective without at least some visible means of enforcement. It has been, and remains, the contention of PMAA that much of the motor fuel excise tax evasion is a direct result of the lack of any measurable enforcement actions by IRS. Many of the marketers PMAA represents say they have never been audited for excise tax collections. Many others say it has been 10 or more years.

The blame for this lack of enforcement must, of course, lie in part with IRS. But there are plenty of other reasons why evasion was such a problem. Previously, the system of collections made audit and enforcement extremely difficult. This was not as a result of there being too many taxpayers, as some would lead you to believe, but rather, that there were too many tax exempt transactions throughout the distribution process. Because of such numerous transactions an IRS auditor may have to track a load of gasoline through several hands before determining whether the correct level of tax was actually paid.

The Tax Reform Act corrected part of this problem by redefining the point of taxation for gasoline as when the product breaks bulk at the terminal rack and disallowing tax exempt sales to end users downstream and by creating the option of allowing marketers to collect diesel fuel excise taxes from dealers. But, Congress overreacted on gasoline and did not go far enough on diesel fuel. As PMAA has earlier recommended, qualified independent wholesalers should continue to be allowed to remit gasoline excise taxes for their product purchases at the rack to the Treasury and the optional wholesaler collection procedure for diesel fuel should be made mandatory.

We reiterate, however, that no system is going to be effective without a commitment by Congress to provide the enforcement tools necessary and a commitment by the Internal Revenue Service to use those tools. Even the new system of gasoline excise tax collection set to take effect on January 1, 1988 is subject to widespread abuse if not monitored and audited properly. Through all of our conversations with Treasury and IRS officials, PMAA does not sense any stronger commitment to enforcement than there was before the levels of widespread evasion were publicized.

Certainly increased enforcement would cost money. But we believe it would pay for itself. PMAA was shocked to learn, for instance, that the excise tax collection monitoring system is still done manually. Can the government afford not to automate the collection of more than $10 billion in revenues each year?

One basis for concluding that stronger enforcement would pay for itself comes from the Cooperative Federal/State Exchange Project For Excise Taxes On Refined Petroleum Products issued last year. This project was done to determine the feasibility and effectiveness of materially increasing the cooperation between IRS and state personnel in assessing compliance and non-compliance with the payment of excise taxes on certain refined petroleum products.

The results of the diesel fuel phase of this project are astounding. Diesel fuel excise tax returns were audited for 25 remittors in seven different jurisdictions. The program recovered $1.8 million in tax and penalties owed the IRS on diesel fuel taxes alone. This is a return, according to the study, of almost $3,000 per audit hour.

Interestingly, the program also audited related federal tax returns and collected an additional $1.5 million for a return of $6,877 per audit hour.

Several conclusions can be drawn from this analysis.

First, stronger enforcement would, in fact, pay for itself. Secondly, such enforcement cannot come merely through changing the collection procedure, since the results show that those individuals not paying the diesel fuel excise tax are also cheating the government in the payment of other taxes.

Another interesting conclusion to be drawn from this analysis is the returns received by the states that participated in this cooperative effort. They collected only an additional $294,000 on diesel tax collections, 16 percent of the federal collections, and $152,000 on related returns, less than 10 percent of what the IRS found. Clearly, the states are doing a better job at excise tax collection and clearly those individuals who decide to cheat believe they can get away with it easier at a federal than at a state level.

PMAA would therefore make several recommendations:

(1) There should be a greater funding for IRS enforcement in the excise tax collection process. If this cannot be done through general revenues, then we urge acceptance of a recommendation made by the Chief Counsel of the Federal Highway Administration that would permit an interagency agreement between FHWA and the IRS under which

disbursement could be made to the IRS from the Highway Trust Fund for administration of the collection of user fees for the trust fund. Either through general revenues or through the interagency agreement proposed by FHWA, the return would be well worth the cost.

(2) We urge vigorous oversight by the Congress for the excise tax collection procedure to insure that IRS is utilizing all available resources to reduce or eliminate excise tax evasion.

(3) We support the recommendations embodied in the Cooperative Federal/State Exchange Project Study: Diesel Fuel Phase on ways the states and the federal government can cooperate more fully in excise tax collection.

(4) We support the recommendation of FHWA Administrator Ray Barnhardt to create a trial program whereby some states would collect the federal excise tax at the same time they collect their own.

Implementation of these four steps should provide significantly new levels of revenue to the federal government.

## SUMMARY

PMAA again appreciates the opportunity to testify today and we wish to urge again that in debating revenue options to meet the requirements of House Concurrent Resolution 93, that the committee keep five basic principles in mind. These include:

(1) The full public policy implications of specific revenue options must be debated and realized before adoption.

(2) The first source of new revenue be collection of taxes already owed but not paid. This would include modification of the gasoline and diesel fuel excise tax collection procedure, as recommended, as well as funding for stronger enforcement efforts by IRS.

(3) Any new revenue options be as broad based as possible in order to insure fairness and equity to everyone.

(4) Current government subsidy programs which are costly to the government and no longer serving a public purpose, such as the excise tax exemption for gasohol, should be eliminated.

(5) Regressive or regionally discriminatory taxes such as excise tax increases, oil import taxes, or broad based energy taxes be rejected.

I will be happy to answer any questions you may have.

## STATEMENT OF CHARLES DI BONA, PRESIDENT, AMERICAN PETROLEUM INSTITUTE, WASHINGTON, DC

Mr. DiBona. Thank you, Mr. Chairman. I am Charles J. DiBona, President of the American Petroleum Institute. The API is a trade association representing all segments of the petroleum industry.

API's longstanding policy favors slowing the growth of spending as the means of reducing Federal deficits. However, we recognize that the Congress has already made its decision on that issue, and the Finance Committee is faced with the extremely difficult task of providing a specific amount of new revenues.

The requirement for large tax increases has generated a variety of energy tax proposals, many of them aimed at the petroleum industry and its products.

My written statement addresses the specific proposals. In my oral comments, I will focus on general concerns which we would urge the committee to consider as you review the many tax increase options.

First, in the interest of economic efficiency and of basic fairness to workers and investors, heavy new taxes should not be imposed on one industry or on just a few industries and their products in order to address what is clearly a national problem.

Economists have demonstrated that imposing large taxes on a few products distorts economic decisionmaking and resource allocation.

Furthermore, it is unfair to those who have committed their labor or their capital to those endeavors. In this regard, I am pleased to see that the Senate two nights ago voted to remove the so-called "windfall profits tax," a tax that is unique in burdening a single industry and which has cost the American people almost 1 million barrels a day in domestic production.

Second, we are concerned about the negative impacts that new energy taxes would have on the economy. These should not be ignored. All taxes including energy taxes will have a negative short-run economic impact.

In addition, any energy taxes would worsen the competitive position of U.S. manufacturers, particularly those in energy intensive industries competing with foreign manufacturers, tend to reduce overall efficiency in the economy, adversely affect indviduals directly by higher energy costs and indirectly by higher costs of goods, and disproportionately burden low income people.

For example, some have suggested increasing the gasoline tax as a means to raise new revenues. No doubt, some monies would be raised in this way, but this would come at the cost of imposing relatively greater burdens on low income persons and on consumers themselves.

It would also aggravate inflation, reduce economic growth, and would further reduce jobs and income in the domestic petroleum industry.

That brings me to our third concern—the current state of the petroleum industry.

Last year, the price of oil dropped by about one-half from previous levels. The impact on the petroleum related support industries has been dramatic.

Even before 1986, profitability, capital expenditures, and exploration and production, drilling activity, well completions, and industry employment had all been heading downward.

Last year, these trends greatly accelerated. Capital investment was slashed. Drilling and other oilfield activity plummeted, with some indicators hitting all-time lows.

Employment declined by 170,000 people, not even counting indirect impacts on support industries such as banking and real estate.

Rates of return on investment—the signal of the attractiveness of an industry to new infusions of capital—fell to less than two-thirds the level of other industries.

The situation in 1987 is only slightly better. The recent stabilzation of crude oil prices has at least stemmed the downward trends; but drilling activity has not much increased, employment is still way down, and while earnings may increase over the low levels of a year ago, rates of return are still well below those elsewhere.

All of this suggests that new taxes on the petroleum industry would be inappropriate in the extreme. They would further weaken cash flows, employment, investment, and general activity. We see no justification for such policy actions.

While the API is not advocating the option of any specific new taxes, we do suggest that, if Congress in addressing the deficit intends to raise revenues, a broad-based tax meeting the following minimum standards would have the least adverse impact on the economy.

One, it should avoid penalizing U.S. manufacturing in domestic and foreign markets by uniformly increasing the cost of goods sold in the United States, regardless of where produced, while not increasing the cost of goods exported from the United States.

Two, it should be neutral in impact on individual competitors and industries with regard to choice of investment or consumption expenditures or form of organization.

Three, it should not sharply affect the distribution of the overall tax burden by being overly regressive or progressive.

And it should avoid negative impact on incentives to save and invest.

I appreciate the opportunity to testify today. I would be happy to answer any of your questions; but before I terminate, let me simply say that I would support what has been said about the proposal to change the point of collections of the gasoline excise tax.

It would have all of the bad effects that the previous speaker mentioned. It would be a subsidy to a very small number of large importers of foreign products. It would be paid by consumers far distant from refineries, and you should not force those consumers to subsidize a few large importers of foreign product.

Senator BAUCUS. Thank you very much, Mr. DiBona. Next, we have Mr. Joseph Ackell.

[The prepared statement of Mr. DiBona follows:]

## STATEMENT OF THE

## AMERICAN PETROLEUM INSTITUTE

### INTRODUCTION

This written statement is intended to accompany the oral statement of Charles J. DiBona, President of the American Petroleum Institute before the Senate Finance Committee regarding revenue increase options. The API is a trade association representing all segments of the petroleum industry.

The Budget Resolution for Fiscal Year 1988 calls for legislation to raise revenues of some $64 billion over the next three fiscal years. API's long-standing policy favors slowing the growth of spending as the means of reducing federal deficits. However, we recognize that the Congress has already made its decision on that issue and the Finance Committee is faced with the extremely difficult task of providing a specified amount of new revenues.

The requirement for large tax increases--$19.3 billion in FY 1988 alone--has generated a variety of energy tax proposals, many of them aimed at the petroleum industry and its products. This statement will address certain of those proposals, and will also set out some general concerns which we would urge the Committee to consider in its review of the many tax increase options.

First, in the interest of economic efficiency and of basic fairness to workers and investors, heavy new taxes should not be imposed on one industry and its products, or on just a few industries and their products in order to address what is clearly a national problem. Economists have demonstrated that imposing large taxes on a few products distorts economic decision making and resource allocation, and thus reduces national wealth. Furthermore, burdening one or a handful of industries is unfair to those who have committed their labor or their capital to those endeavors. The Federal budget deficit is a problem that impacts every sector of our economy and affects all of our citizens. The task of addressing it should be spread as widely as possible through our society.

Second, new taxes on the petroleum industry would be inappropriate in the extreme. Last year, the price of oil dropped by about one half from previous levels. The impact on the petroleum and related support industries has been dramatic.

Even before 1986, profitability, capital expenditures on exploration and production, drilling activity, well completions and industry employment had all been heading downward. Last year, these trends greatly accelerated.

--Capital investment was slashed.

--Drilling and other oil field activity plummeted, with some indicators hitting all-time lows.

--Employment declined by 170,000 people, not even counting indirect impacts on support industries such as banking and real estate.

--Rates of return on investment, a signal of the attractiveness of an industry to new infusions of capital, fell to less than two thirds the level of other industries.

The situation in 1987 is only slightly better. The recent stabilization of crude oil prices has at least stemmed the downward trends. But drilling activity has not much increased, employment still is way down, and while earnings may increase over the very low levels of a year ago, rates of return still are well below those elsewhere.

New taxes on the petroleum industry would further weaken cash flows, employment, investment and general activity. We see no justification for such policy actions.

## ENERGY TAXES

### A. General

All taxes -- including energy taxes -- will have a negative short-run economic impact. The Consumer Price Index (one measure of inflation), Gross National Product growth (output) and employment will all be adversely impacted by enactment of an energy tax. The short-run "feedback-effects" due to lower economic activity would tend to offset, to some degree, the anticipated federal deficit reduction amounts. Moreover, the accompanying higher energy prices could very well reverse the deficit-improving stimulus of recent lower oil prices.

Imposing an energy tax would also create a competitive disadvantage for U.S. manufacturers both domestically and internationally. Unlike the 1970's oil price shocks, a unilateral energy tax will hurt only U.S. industries. U.S. manufacturers would be disadvantaged compared to foreign competitors who could send their products into the U.S. free of the cost of the tax. Exported U.S. goods would be similarly disadvantaged in world markets. Traditional heavy consumers of energy such as agriculture and "smokestack" industries are likely to be harmed more by an energy tax than by other forms of taxes. There would also be a disproportionate negative impact on domestic auto sales and auto industry suppliers. Other energy-dependent industries such as steel, petrochemical, and aluminum would have higher production costs, lower capacity utilization, and more unemployment.

Individuals would also be adversely affected by the imposition of an energy tax--both directly and indirectly. Such a tax would raise the price to consumers of energy with no corresponding offset to their disposable incomes. Thus, an energy tax would tend to have the same effect as increasing personal income taxes.

Individuals would also be indirectly affected by higher product prices due to businesses' increased production costs. These higher prices would also contribute to a general increase in the inflation rate.

Additionally, the assumption that energy taxes involve only a relatively small number of taxpayers is faulty. Thus, it must be recognized that energy taxes will result in high administrative and compliance costs.

Finally, as noted earlier, the situation in the petroleum industry today is dramatically different from that of just a few years ago. A new energy tax would tend to shrink the market for petroleum products, causing further losses of facilities and jobs in all sectors of the industry, and would lead to increased reliance on imported petroleum in the future.

For each of these reasons, any tax increase which singles out energy will have a discriminatory impact on a number of key sectors of the U.S. economy. This is neither equitable nor efficient.

## B. Broad-based Energy Taxes

### 1. BTU Tax

Under this proposal, a broad-based excise tax would be imposed on most fuels (domestic and imported oil, natural gas, coal, nuclear energy and electric power) based on energy content (BTU's). One of the major drawbacks to this proposal, in addition to the general negative features discussed earlier, is its tendency to exacerbate market distortion among the various fuels because it would be based on energy content rather than price. For example, low-price natural gas would bear a disproportionately large amount of tax relative to its price. As another example, there would be price distortions due to the tax among anthracite, bituminous and lignite coal or between high and low-sulfur crude oil. Substantial pyramiding of the tax would also occur unless some sort of credit mechanisms for energy consumed in producing other energy were devised.

### 2. Ad Valorem Energy Tax

This mechanism is sometimes suggested as the alternative to the BTU tax because this method addresses the inherent differences in value attributable to the variations in BTU content and quality or location differences. As with the BTU tax, a broadly based excise tax would be imposed on most fuels. The value approach would avoid creation of new market distortions. However, the same risk of pyramiding (*i.e.*, imposing a tax on energy used to produce other energy) which occurs with the BTU tax is inherent in this method, and some credit or refund mechanism to avoid the build-up of taxes is critical. The same general adverse effects of an energy tax noted in the first section -- reduced GNP, increased inflation, harm to U.S. industries' competitive position in foreign and domestic markets, increased costs to consumers, etc. -- apply to this tax proposal as well as all the others discussed herein.

### C. Broad-based petroleum tax

In general, because an "oil only" tax would be imposed on a narrower base than an all energy tax, the rate of tax would be higher and the effects on oil using consumers--both individuals and industries--correspondingly more severe. An oil-only tax would be particularly damaging to industries that use relatively large amounts of oil as inputs, such as the petrochemical and agricultural industries. Such a tax would also reduce the demand for products such as automobiles that use oil products intensively. In addition, an oil only tax would create regional inequities in the per capita cost of energy. Those sections of the country most heavily dependent on crude oil and its products for heating and transportation would bear more of the tax burden than other areas. It can be expected that political pressures would mount to exempt certain products (e.g., heating oil) from an oil-only tax. Such exemptions would increase the burden on non-exempt users in order to raise a given amount of revenue, and also would increase the administrative complexity of the tax.

### D. Motor fuels tax increases

Some have suggested increasing the gasoline tax as a means to raise new revenues. No doubt some monies could be raised in this way, but it would come at the cost of imposing relatively greater burdens on low income persons and on consumers in the West and South. Just as with a tax on all oil, it would aggravate inflation and reduce economic growth, and would further reduce jobs and income in the domestic petroleum industry.

### E. Gasoline Tax Collection at Refinery Gate

One of the options listed by the Joint Committee on Taxation would provide for collection of the gasoline excise tax at the refinery gate. API opposes this proposal.

The Tax Reform Act of 1986 included a major change in the method of collection of the federal gasoline tax to go into effect January 1, 1988. All segments of the industry worked with the tax writing committees and the Treasury to devise a system which all agreed would address the problem of tax evasion and still maintain relative competitive neutrality of the gasoline marketing system.

Moving the point of collection to the refinery gate would cause major changes in the gasoline manufacturing and distribution systems which could lead to competitive distortions and to spot shortages of gasoline.

## INTANGIBLE DRILLING COSTS AND PERCENTAGE DEPLETION

### A. General

Several revenue raising options involve modifying the tax treatment of intangible drilling costs and depletion. These proposals include repealing expensing of IDCs, repealing the remaining percentage depletion for independents, increasing the percentage of Sec. 291 cutbacks, and across-the-board reductions in the value of certain preferences including IDC and excess percentage depletion. API opposes such proposals because they would have the effect of making oil exploration and production activities less profitable and thereby cause a reduction in investment.

### B. Intangible Drilling Costs

Intangible drilling and development costs (IDCs) are costs incurred for items which, in themselves, have no salvage value and are "incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." Treas. Reg. 1.612-4(a). Such costs expressly include wages, fuel, repairs, hauling, supplies, etc., which are incurred in the drilling of wells, in the clearing of ground, and in the construction of derricks, tanks and other physical structures that are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

Under Sec. 263(c) of the Internal Revenue Code and Treasury Regulations promulgated thereunder, taxpayers are permitted to deduct currently IDCs for oil and gas wells and wells drilled for geothermal deposits in the United States. Only the holder of a "working" or an "operating" interest (i.e., the interest which is burdened with the risks and costs of developing and operating the property) may currently deduct IDCs. Moreover, the election to deduct IDCs must be made by the taxpayer for the first taxable year in which such costs are incurred and is binding for all subsequent years. Sec. 291(b) requires that in the case of an integrated oil company, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.

Current deduction of IDC expenditures has been a part of oil and gas tax law since the inception of the income tax. The tax treatment of IDCs was an outgrowth of the fact that many taxpayers considered the expensing of such costs to be an acceptable accounting practice. The treatment was also justified as a means of encouraging the exploration and development of our nation's oil and gas resources. Its importance is widely recognized as it helps to attract investment into oil and gas development despite the high financial risks and costs. The development of domestic oil and gas resources still can be aided by the rapid recovery of IDCs for tax purposes. Indeed, financial risks have escalated as the industry must more frequently drill in high-cost, hostile offshore and frontier environments. Many members of the industry, both large and small, do not readily have the cash resources or borrowing ability to carry the additional costs imposed by deferring deduction of drilling expenditures. For many taxpayers, the immediate cash flow generated by the IDC deduction can be an absolute prerequisite to participation in the industry.

## C. Depletion

The Tax Reduction Act of 1975 added Sec. 613A of the Internal Revenue Code to eliminate percentage depletion on oil and gas production. Certain exemptions were provided, however, including a limited exemption for independent producers and royalty owners. API believes that percentage depletion was and remains an effective replacement cost recovery mechanism which encourages exploration and production of oil and gas by recognizing the high risks and the enormous capital outlays required to replace reserves today in the industry.

Congress first adopted percentage depletion in 1926 as a replacement for "discovery value depletion". Percentage depletion is designed to encourage drilling activity and to approximate the cost of replacing reserves currently produced. Depletion calculated on the percentage method allows the owner of the oil or other wasting natural resource to recover a percentage of gross income subject to certain limitations. In the case of oil and gas, the current rate of percentage depletion for those eligible is 15 percent.

Many of the underlying reasons for enacting percentage depletion initially, i.e. high risk and high cost for replacing a depleting asset, justify its continuation today. Risks remain high; the industry experienced dry holes on over 80% of all wildcat wells drilled. Furthermore, domestic production has begun to decline again so that efforts to encourage domestic production are needed to stem the decline.

Rising prices through 1980 encouraged the oil and gas driller in finding oil and gas. Undoubtedly, however, some wells were not drilled and some production was forfeited by the removal of percentage depletion for integrated oil companies. Last year the price of oil dropped by about one half from previous levels, and the situation in 1987 is only slightly better. Percentage depletion ameliorates the effect of the price decline to some extent for independent producers. API believes that percentage depletion was and remains an effective replacement cost recovery mechanism which encourages the production of oil and gas.

## CONCLUSION

New or increased taxes on the petroleum industry would further reduce returns on investment and sources of funds to an industry already devastated by declining prices. Furthermore, new taxes on energy, depending on their form, will either jeopardize the energy or the economic well-being of this country, or will do both.

While the API is not advocating the adoption of any specific new taxes, we do suggest that if Congress, in addressing the deficit, intends to raise revenues, a broad-based tax meeting the following minimum standards would have the least adverse impact on the economy:

1. It should avoid penalizing U.S. manufacturing in domestic and foreign markets by uniformly increasing the cost of goods sold in the U.S. regardless of where produced, while not increasing the cost of goods exported from the U.S.

2. It should be neutral in impact on individual competitors and industries with regard to choice of investments or consumption expenditures or form of organization.

3. It should not sharply affect the distribution of the overall tax burden by being overly regressive or progressive.

4. And, it should avoid negative impact on incentives to save and invest.

## STATEMENT OF JOSEPH J. ACKELL, SENIOR VICE PRESIDENT AND CHIEF LEGAL OFFICER, NORTHVILLE INDUSTRIES CORP., TESTIFYING ON BEHALF OF THE INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION, MELVILLE, NY

Mr. Ackell. Thank you, Mr. Chairman. I am here on behalf of ITOA, the Independent Fuel Terminal Operators Association. We operate petroleum distribution terminals up and down the east coast of the United States.

We distribute petroleum products that arrive at our terminals by pipelines from domestic refineries and from ocean-going tankers, in the case of imports, and of course, barge traffic and tanker traffic in domestic waters.

I am here for the limited purpose of endorsing the change that is proposed in the Joint Committee's Options Report that the gasoline excise tax point of collection be moved to what we call the refinery gate, in the case of domestic gasoline, and to the point of import in the case of imports; and by that we mean the United States Customs Service as the collector of the tax.

In addition, we support the proposal that remissions of those taxes that now occur twice a month be changed so that electronic transfers occur once a week to eliminate the advantage that results from any particular segment of the market, receiving by the collection of taxes amounts of money that are not remitted until later dates.

My personal experience and that of my company involves New York. New York went through a very difficult experience in recent years on evasion of gasoline taxes.

The evasion magnitude at one point in New York reached $200 million a year of evaded taxes, and it affected every aspect of the petroleum industry that is involved in gasoline.

In our case, it affected our retail gasoline sales. It affected ou wholesale gasoline sales. And it affected the amount of gasoline that the major oil companies and independents would move through our terminal and pipeline and rack delivery system.

New York finaly changed the point of collection to the point of first sale or first import. I was involved in my company with the Governors's task force formulating that legislation and as well with the Organized Crime Strike Force formed in the Eastern District of New York, which ended up indicating many people in organized crime that participated in the massive tax evasion.

That evasion remains today in New York and elsewhere Federal excise taxes on gasoline. It has been estimated to amount to close to $1 billion a year of evasion.

It is our belief that the change proposed in the Tax Reform Act of 1986 and to become effective January 1, 1988, has a substantial chance to not accomplishing the purpose for which it was enacted. And that purpose was to eliminate evasion.

Mr. Chisholm, in his testimony, said that moving the point of collection to the refinery gate will not, in his judgement, lessen the amount of evasion.

If you think about it, was we are saying is: Simplify the point of collection. Reduce the number of collectors and be able to audit it more efficiently.

It does not adversely affect the competition. It does not increase the amount of import, and it and not increase consumer prices. It simply levels out the payment of taxes and causes that occurrence to be at the earliest possible point and therefore avoid to the greatest extent evasion that is now occurring and may even be increased in its extent if the point of collection is midstream rather than all the way upstream at the refinery gate.

Thank you.

Senator BAUCUS. Is that it?

Mr. ACKELL. That is it.

Senator BAUCUS. Next is Mr. Richard Barnett.

[The prepared statement of Mr. Ackell follows:]

# STATEMENT
# of the
# INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION

Mr. Chairman:

I am Joseph J. Ackell, a Senior Vice President and Chief Legal Officer of Northville Industries Corp. of Melville, New York. Northville is an independent marketer and trader of refined petroleum products principally in the Mid-Atlantic states; we operate several deepwater terminals in New York and New Jersey with approximately 11 million barrels of storage capacity.

I am appearing today on behalf of the Independent Fuel Terminal Operators Association ("IFTOA"). IFTOA strongly supports the Joint Committee proposal to move the collection point for federal gasoline excise taxes to the top of the petroleum distribution system. This revenue option appeared in the "Description of Possible Options to Increase Revenues prepared for the Committee on Ways and Means" by the staffs of the Joint Committee on Taxation and the Committee on Ways and Means.[1/] It simply builds on the efforts of the Congress in the last session to eliminate gasoline tax evasion.

IFTOA is composed of 19 companies which operate 57 deepwater and 42 barge oil terminals along the East Coast from Maine to Florida.[2/] None is affiliated with a major oil company. Members are primarily marketers of residual fuel oils (Nos. 4, 5 and 6 fuels) and home heating oil (No. 2 fuel); several companies

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[1/] U.S. Government Printing Office, "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means" at 66 (June 25, 1987).

[2/] A list of members and a description of the Association is attached. (Attachment A).

also market significant volumes of gasoline at wholesale and retail levels. Members handle nearly 50% of the non-utility residual fuel oil shipped to the East Coast, nearly 60% of the non-utility residual fuel oil shipped to New England, 25% of the No. 2 heating oil shipped to the East Coast, and nearly 50% of the No. 2 heating oil shipped to New England.

## I. Current Law

Current federal law provides for a tax of 9.1 cents per gallon on motor gasoline. Section 4081 of the Internal Revenue Code. The tax is designed to be imposed at the manufacturer's level; however, in many situations the tax may be deferred to the end of the distribution chain through tax-exempt transfers. Thus, the tax is generally collected and remitted to the Internal Revenue Service by either the distributor selling gasoline to the retail marketer or the retail marketer.

Unfortunately, this system of deferral has resulted in substantial tax evasion. Firms have engaged in complex transactions to obscure recognition of the taxable entity, including but not limited to "daisy chain" operations; in these transactions companies operating with invalid tax exempt certificates purchase gasoline and resell the product many times in paper transactions.[3]

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[3] Numerous bogus or "shell" corporations have been able to obtain tax exempt certificates. In other cases, otherwise legitimate firms hold forged or cancelled certificates. Because the Federal Government does not maintain a centralized (footnote continued)

Last July, the Subcommittee on Oversight of the House Committee on Ways and Means held a hearing to determine the magnitude of the problem. Treasury officials estimated the loss of revenue to the Federal Government from such evasion to be about $200 million annually. A private consulting firm, National Economic Research Associates, Inc., published a report this January placing the loss at more than $500 million; the Federal Bureau of Investigation testified last summer and more recently stated its conclusion that gasoline tax evasion costs the government as much as $800 million per year.[4/] Finally, a gasoline marketer, who had been involved in elaborate tax evasion schemes in New York, testified that the loss was closer to $1 billion annually. These amounts represent significant losses to the Federal Government.[5/]

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(footnote continued from previous page) list of tax exempt certificates, it is not possible for distributors who deal with such firms to verify the validity of a certificate presented to them.

[4/] Pasztor, Andy and Gutfeld, Rose The Wall Street Journal, "Fuel Fraud," p. 1 (February 6, 1987).

[5/] Tax evasion not only deprives Federal and state governments of taxes owed; it also places legitimate businessmen at a substantial competitive disadvantage. For example, in the State of New York federal and state gasoline taxes total about 30 cents per gallon. If a company is able to avoid paying that tax liability, it can undersell honest businessmen by a substantial amount and greatly diminish their market share. The consumer may benefit from this initial dishonesty through lower gasoline prices; however, the consumer will ultimately pay higher taxes in other contexts to compensate for the loss of gasoline tax revenues.

## II. Tax Reform Act

To address this problem, the Tax Reform Act of 1986 (P.L. 99-514) moved the point of collection of the tax, effective January 1, 1988, "up stream" to the refiner, importer or terminal operator. Specifically, the law provides:

1. if a refiner or an importer (a non-terminal operator) removes oil from a facility or sells it, without transferring the oil in bulk to a terminal operator, the refiner or importer will collect the tax;

2. a bulk transfer of gasoline from a refiner or importer to a terminal operator is not considered a removal or sale; and

3. if a terminal operator receives gasoline, it collects the tax on the earlier of (a) the removal or (b) the sale of the gasoline.[6]

The Treasury Department plans to issue proposed regulations to implement this provision in the near future. It appears that those regulations will, in most instances, make removal from the terminal the taxable event.

## III. Proposed Revenue Option

IFTOA believes that deferring tax collection to the point of removal from the terminal does not satisfactorily correct collection abuses because it continues to provide marketers with significant opportunities to avoid the payment of the tax, and it may even have the unintended result of actually increasing the evasion. For example, once gasoline enters a terminal, particularly oil not owned by the terminal operator, it can be bought and sold many times over.[7/] Such turnover makes it difficult to trace the ownership of the oil leaving the terminal and increases the likelihood that the tax will remain unpaid.

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[6] The law does not address the issue of how to handle shipments between terminals or exchanges.

To implement Congressional intent and avoid tax evasion, IFTOA recommends that Congress adopt the collection amendment proposed in the Description of Options. The amendment should include the following elements:

1. Domestic Gasoline

Tax is imposed upon the removal of gasoline from the refinery; it is paid and collected by the refiner.

2. Imported Gasoline

Tax is imposed at the port of entry when it enters the United States; it is paid by the importer of record and collected by the U.S. Customs Service.

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[7/] In many instances importers of refined petroleum products do not own their own terminal and storage facilities. Thus, they retain the services of a terminal operator to perform the function of unloading the vessel and placing the oil in storage for subsequent distribution. For these services they pay a terminalling fee. In these instances the importer, not the terminal operator, holds title to the product.

3. Remittance

To prevent any refiner or terminal operator from obtaining a competitive advantage by holding the collected taxes, remittance to the Federal Government would be required every week. However, the filing requirement of a quarterly tax return would not be changed.

IV. The Float

Gasoline distributors who purchase product from refiners or terminal operators have been advocating that they serve as collectors of the tax. Their objective is to hold the money for a limited time prior to remittance. During this time, these distributors would have use of the funds; they could either deposit the money in an interest-bearing account or use the funds to reduce working capital requirements. The "float", the term used to describe the holding of the collected tax revenues, is beneficial because it provides a marketer with extra working capital. Currently, these distributors oppose the move of the tax collection point to the refiner or terminal operator because they would like to retain the float which they believe to be significant.

In 1985, the National Economic Research Associates, Inc., a private economic consulting firm, analyzed and quantified the float earned by New York distributors on collection of state taxes.[8] NERA determined that the float was far less significant than originally thought and ranged from $100 to about $500 per month for each distributor. Thus, it was not an essential source of income for such distributors. An analysis of the value of the float based on the collection of federal taxes is likely to produce a simiiar conclusion.

Moreover, placing the point of collection further down the distribution chain to provide certain marketers with the "float" undermines the purpose of the law -- to eliminate or at least substantially reduce tax evasion. Any benefits from the float are far outweighted by the threat of greater fraud and tax evasion.[9]

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[8] Evasion of gasoline excise taxes has been a significant problem in New york during the prior five years.

[9] Prior to 1982, New York collected its state and local gasoline taxes from gasoline retailers. This method proved to be burdensome; the large number of retailers (about 10,000) and their rapid turnover made administration and enforcement difficult. In an attempt to deal with this problem, New York State passed legislation in 1982 to collect these taxes from distributors, rather than retailers (as is now being proposed by the distributors), because there are only about 400 distributors statewide; it was thought that collecting taxes at this level would be easier to administer and enforce.

Unfortunatley, the legislation had the unintended effect of increasing significantly the financial incentives for gasoline tax evasion. Because the volume of gasoline handled by the average distributor was much greater than that handled by the average retailer, the amount of taxes to be paid by individual distributors was correspondingly larger. To evade these taxes, a variety of schemes was invented to sell gasoline without reporting the taxes to the State. Beginning in the last quarter of 1982, there was an upsurge in

(footnote continued)

## V. Increased Taxes

At present there is much discussion in Congress about increasing the federal gasoline excise tax. For example, a revenue proposal to increase the tax by 5 or 10 cents per gallon appears in the Revenue Options booklet.[10] Assuming such a proposal is enacted, there will be substantially greater monetary incentive for tax evasion.

## VI. Conclusion

Accordingly, the Independent Fuel Terminal Operators Association urges that Section 4081 of the Internal Revenue Code be amended to permit the imposition and collection of the federal gasoline excise tax at the earliest point of distribution. Such a measure would minimize tax evasion and bring substantial additional revenue annually to the Federal Government even at current tax rates. This proposed method of collection would more efficiently implement the objectives of the section originally adopted by the Congress as part of the Tax Reform Act last fall.

Thank you very much.

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(footnote continued from previous page)
bootleg and other unreported gasoline sales; these sales resulted in lost tax revenues for the State and its localities and injured legitimate distributors who competed against dealers selling illegally low-priced gasoline. To correct the problem, in late 1985 New York moved the point of collection to the first import or sale. This change proved successful; in the first year following its implementation, the State of New York collected more than $160 million of additional revenue.

[10] U.S. Government Printing Office, "Description of Possible Options to Increase Revenues prepared for the Committee on Ways and Means" at 63 (June 25, 1987).

## STATEMENT OF RICHARD BARNETT, CHAIRMAN, ALLIANCE FOR RESPONSIBLE CFC POLICY, YORK, PA

Mr. BARNETT. Thank you, Mr. Chairman.

Senator BAUCUS. You are Chairman of the Alliance for Responsible CFC Policy.

Mr. BARNETT. Yes, sir, and we have talked before.

Senator BAUCUS. Yes, we have.

Mr. BARNETT. The Alliance is here today to express concern for the proposed tax on CFCs being considered as a revenue raising option. We believe this, in fact, is trying to solve and address an environmental issue with a tax policy.

This policy could interfere with the delicate international negotiations on CFC controls and would further disadvantage U.S. industry in its attempts to maintain industry competitiveness in world markets.

Most disturbing is the signal that this action would send to the world competitors with whom we are now negotiating an international agreement for the protection of the ozone layer.

These rigorous negotiations under the auspices of the United Nations environmental programs are expected to produce an international agreement on the control of CFCs by the end of 1987.

In 1978, the U.S. banned the use of CFCs in aerosol spray cans. Very few countries followed this action. Today, aerosol sprays are still the single largest use of CFCs outside the United States.

The lesson is clear. Unilateral action served only to penalize U.S. economy and produce little environmental benefit.

During 1986 and 1987, Government, industry, and environmental organizations in the United States have cooperated amazingly in assessing the scientific bases and the economic feasibility of proposed control measures on CFCs.

And they have had a significant impact on negotiations under UNEP. The UNEP negotiations are expected to produce an agreement by the end of this year that is both environmentally protective and economically feasible.

Now is not the time to alter the balance of these negotiations by pursuing a unilateral program such as a tax of CFCs.

A tax on these compounds is likely to siphon off money needed by U.S. industry to pursue the research and development necessary to find new CFC compounds and to develop products utilizing these compounds.

Although the use of current compounds such as CFC–22 can be extended and are considered to be part of the solution—and I want to repeat that—are considered to be part of the solution, not part of the problem.

Some proposals, such as House bill 2854, include a tax on CFC–22. This is a dramatic mistake and must be corrected.

The search for substitute compounds is well under way. In our view, no additional incentive is necessary to spur this development. The tax could, in fact, slow down the development of substitutes by taking money away from industries research and development programs.

A freeze on the production of these compounds, as anticipated within the UNEP negotiations, is likely to cause signficant immediate price increase of CFCs.

The cost to the U.S. economy of a freeze alone is estimated to be greater than $1 billion.

A CFC tax would only worsen the economic penalty on the U.S. users and consumers with no similar effect on our world competitors.

This precisely is the type of penalty that we have tried to avoid by pursuing an international negotiation under UNEP. This tax proposal is ill-advised and ill-timed.

The U.S. industry has urged the Government to support policies on CFCs that protect the environment and U.S. jobs.

An international agreement to accomplish these two objectives is within our grasp. To disrupt the international agreement would be a tragedy for both world environmental progress and for United States industry.

Thank you very much.

Senator BAUCUS. Thank you very much, Mr. Barnett.

[The prepared statement of Mr. Barnett follows:]

## ALLIANCE FOR RESPONSIBLE CFC POLICY

Good morning Mr. Chairman, Members of the Committee. My name is Richard Barnett, I am Vice President and General Manager of York International, Central Environmental Systems Division, in York, Pennsylvania. I am appearing on behalf of the members of the Alliance for Responsible CFC Policy, a coalition of more than 500 users and producers of chlorofluorocarbons (CFCs) in the United States.

The Alliance is here today to express concern for the proposed tax on CFCs being considered as a revenue raising option. This proposal is the wrong policy at the wrong time as it could interfere with delicate international negotiations on CFC controls and would further disadvantage U.S. industry in its efforts to remain competitive in the world marketplace.

Perhaps most disturbing is the signal that this action would send to world competitors with whom we are now negotiating an international agreement for the protection of the ozone layer. These complicated negotiations under the auspices of the United Nations Environment Programme (UNEP) are expected to produce an international agreement to control CFCs by the end of 1987. This is not now the time for the United States to indicate its intent that it is once again going to pursue the failed policy of unilateral action on CFC compounds.

In 1978, the U.S. banned the use of CFCs in aerosol spray cans. One EPA study estimated the cost to the U.S. economy from this action to be $1 billion and the loss of 8,700 jobs. Few countries followed this action. Today, aerosol sprays are still the single largest use of CFCs outside the United States. The lesson is clear--unilateral action served only to penalize the U.S. economy and produced little environmental benefit.

Recognizing the environmental ineffectiveness of unilateral action as well as the economic disadvantages to U.S. consumers, the CFC Alliance has urged that efforts to address the need for and implementation of further CFC controls be pursued at the international level. In 1985, the Vienna Convention for Protection of the Ozone Layer was signed by more than twenty countries to establish a framework for international cooperation and information exchange on the need for control measures to protect the ozone layer.

During 1986 and 1987, government, industry, and environmental organizations in the United States have exhibited a remarkable level of cooperation in assessing the scientific basis and economic feasibility of possible control measures on CFCs. This process has also had a significant beneficial impact on the negotiations at UNEP which resumed last December. Our government, industry, and environmental organization representatives have exhibited substantial leadership in the development of the CFC protocol agreement.

The UNEP negotiations are expected to produce an agreement by the end of this year. The agreement is likely to include all major producer nations as well as many significant consumer nations. The negotiations are attempting to obtain an agreement that is both environmentally protective and economically feasible. Now is not the time to alter the balance in these negotiations by pursuing a unilateral program such as a tax on CFCs.

As a policy in the United States, a tax on these compounds is likely to siphon off money needed by U.S industries to pursue the research and development necessary to find new CFC compounds, and to develop products utilizing these compounds. Currently, CFCs are widely utilized because of their desirable properties. They are non-toxic, non-flammable, non-corrosive, non-carcinogenic, and very enery efficient in their applications. They are used in many essential industries including air conditioning and refrigeration, automotive, electronics, food processing, plastic-foams and rigid insulation foam, and many others. We have estimated the annual value of goods and services in the U.S directly related to CFCs to be greater than $28 billion. Direct employment is more than 715,000 jobs.

Although the use of current compounds such as CFC-22 can be expanded to replace fully-halogenated CFCs in some applications, both industry and government agree on the need to develop new compounds to replace many of the current CFC uses. EPA's own expert panel concluded that this process could take 4-10 years.

This development process has already begun. In our view, no additional incentive is necessary to spur this development. A tax at this time will be onerous to society which presently has few alternatives to critical needs in refrigeration, electronics, energy conservation and other applications. At its worst, the tax could slow down the development process by taking funds away from the industries' research and development programs.

Furthermore, it should also be pointed out that a policy that taxes compounds that are considered to be part of the solution and not part of the problem, such as CFC-22, could be counterproductive and actually discourage pursuit of some of potential CFC alternatives.

Analysis performed by the economic consulting firm of Putnam, Hayes and Bartlett, of Washington, D.C., has projected that a freeze on the production of these compounds is likely to cause significant immediate price increases in CFCs. The cost to the U.S. economy from a freeze alone is estimated to be greater than $1 billion by the year 2000. In actuality, the UNEP agreement is likely to go much further than a freeze, e.g., as much as 20% reduction in CFC emissions has been reported to be possible, therefore, it is not unreasonable to conclude that the costs will be much higher than $1 billion.

A CFC tax would only worsen this economic penalty on the U.S users and consumers with no similar effect on our world competitors. This is precisely the type of penalty that we have tried to avoid by pursuing the international negotiations at UNEP.

Finally, as can be some from the attached chart on the estimated value of imports and exports of products used or made with CFCs, the trade impacts could be significant for U.S. industries. It would be difficult or impossible to develop a fair monitoring system to try to impose a tax on some of the imported products containing or made with CFCs.

The U.S. industry has urged the government to support a policy on CFCs that protects the environment and U.S. jobs. An international agreement to accomplish these two objectives is within our grasp. To revert now to old policies that can only hurt U.S. consumers and our competitiveness worldwide would be a tragedy for world environmental progress and for the United States.

Thank you.

CFC - AN ECONOMIC PORTRAIT OF THE CFC UTILIZING INDUSTRIES IN THE UNITED STATES

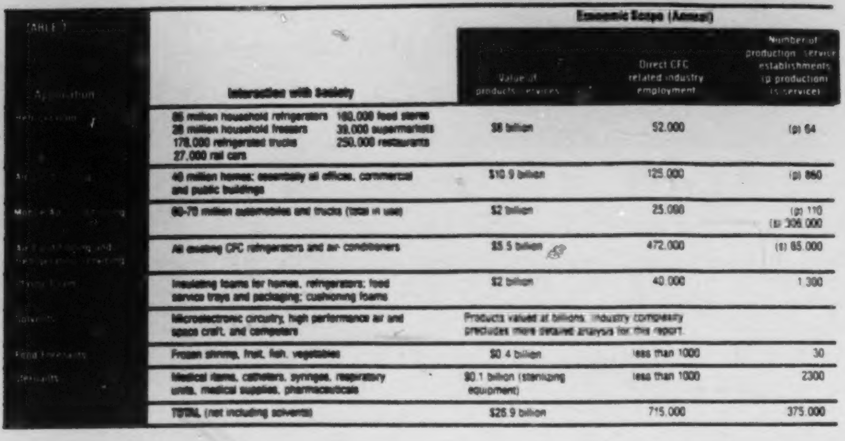

TABLE 1

| Application | Interaction with Society | Economic Scope (Annual)<br>Value of products services | Direct CFC related industry employment | Number of production service establishments (p production) (s service) |
|---|---|---|---|---|
| Refrigeration | 85 million household refrigerators 160,000 food stores<br>28 million household freezers 30,000 supermarkets<br>178,000 refrigerated trucks 250,000 restaurants<br>27,000 rail cars | $8 billion | 52,000 | (p) 64 |
| Air Conditioning | 40 million homes; essentially all offices, commercial and public buildings | $10.9 billion | 125,000 | (p) 860 |
| Mobile Air Conditioning | 60-70 million automobiles and trucks (total in use) | $2 billion | 25,000 | (p) 110<br>(s) 306,000 |
| Air Conditioning and Refrigeration Servicing | All existing CFC refrigerators and air conditioners | $5.5 billion | 472,000 | (s) 65,000 |
| Plastic Foam | Insulating foams for homes, refrigerators; food service trays and packaging; cushioning foams | $2 billion | 40,000 | 1,300 |
| Solvents | Microelectronic circuitry, high performance air and space craft, and computers | Products valued at billions. Industry complexity precludes more detailed analysis for this report. | | |
| Food Freezants | Frozen shrimp, fruit, fish, vegetables | $0.4 billion | less than 1000 | 30 |
| Sterilants | Medical items, catheters, syringes, respiratory units, medical supplies, pharmaceuticals | $0.1 billion (sterilizing equipment) | less than 1000 | 2300 |
| | TOTAL (not including solvents) | $28.9 billion | 715,000 | 375,000 |

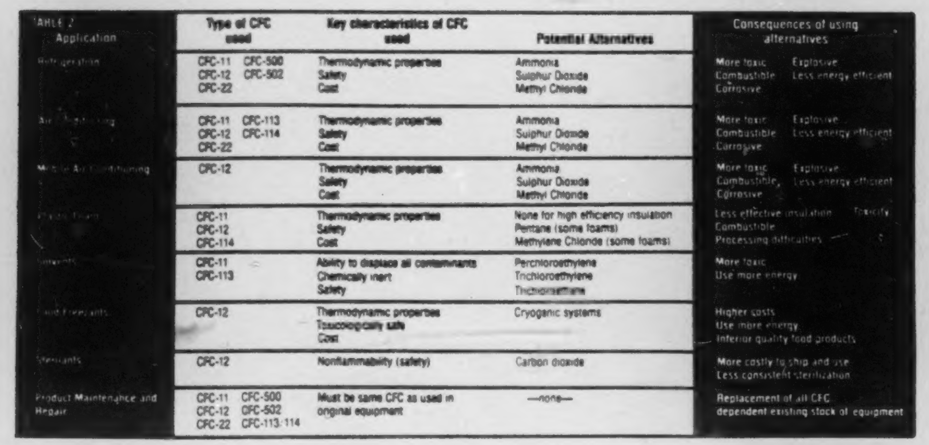

TABLE 2

| Application | Type of CFC used | Key characteristics of CFC used | Potential Alternatives | Consequences of using alternatives |
|---|---|---|---|---|
| Refrigeration | CFC-11 CFC-500<br>CFC-12 CFC-502<br>CFC-22 | Thermodynamic properties<br>Safety<br>Cost | Ammonia<br>Sulphur Dioxide<br>Methyl Chloride | More toxic Explosive<br>Combustible Less energy efficient<br>Corrosive |
| Air Conditioning | CFC-11 CFC-113<br>CFC-12 CFC-114<br>CFC-22 | Thermodynamic properties<br>Safety<br>Cost | Ammonia<br>Sulphur Dioxide<br>Methyl Chloride | More toxic Explosive<br>Combustible Less energy efficient<br>Corrosive |
| Mobile Air Conditioning | CFC-12 | Thermodynamic properties<br>Safety<br>Cost | Ammonia<br>Sulphur Dioxide<br>Methyl Chloride | More toxic Explosive<br>Combustible Less energy efficient<br>Corrosive |
| Plastic Foam | CFC-11<br>CFC-12<br>CFC-114 | Thermodynamic properties<br>Safety<br>Cost | None for high efficiency insulation<br>Pentane (some foams)<br>Methylene Chloride (some foams) | Less effective insulation Toxicity<br>Combustible<br>Processing difficulties |
| Solvents | CFC-11<br>CFC-113 | Ability to displace all contaminants<br>Chemically inert<br>Safety | Perchloroethylene<br>Trichloroethylene<br>Trichloroethane | More toxic<br>Use more energy |
| Food Freezants | CFC-12 | Thermodynamic properties<br>Toxicologically safe<br>Cost | Cryogenic systems | Higher costs<br>Use more energy<br>Inferior quality food products |
| Sterilants | CFC-12 | Nonflammability (safety) | Carbon dioxide | More costly to ship and use<br>Less consistent sterilization |
| Product Maintenance and Repair | CFC-11 CFC-500<br>CFC-12 CFC-502<br>CFC-22 CFC-113/114 | Must be same CFC as used in original equipment | —none— | Replacement of all CFC dependent existing stock of equipment |

SOURCE: ALLIANCE FOR RESPONSIBLE CFC POLICY

Source: Putnam, Hayes & Bartlett, May 1987

FIGURE 1

COST OF WEIGHTED PRODUCTION FREEZE
BY YEAR, 1986-2000

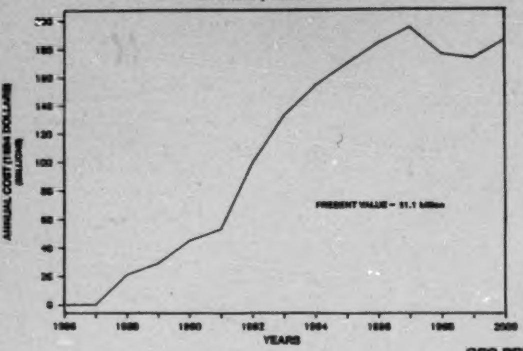

Figure 1 shows cost of weighted production freeze on CFCs 11, 12, and 113. Depending on the availability of substitutes, annual costs will exceed $180 million by the mid-1990s.

FIGURE 2

CFC PRICE INCREASES UNDER FREEZE
1986 to 1997

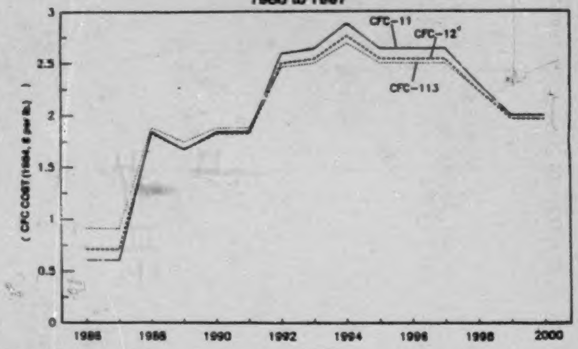

Figure 2 shows anticipated price increases of CFCs 11, 12, and 113 as a result of a production freeze. Prices could double immediately and continue to rise up to 3-4 times current levels until subtitutes become available.

FIGURE 3

CFC USE GROWTH
Weighted CFC Production 11, 12, 113

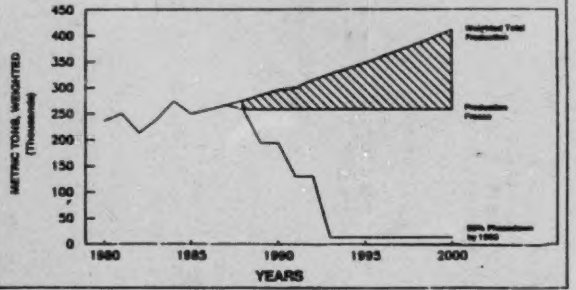

Figure 3 shows the impact of a freeze on the growth in (weighted) total production of CFCs 11, 12, and 113. The freeze reduces cumulative production by approximately 1.1 million metric tons relative to the no regulation case. This amount is equivalent to about four years at current production levels.

## RECAP OF F/C RELATED IMPORTS/EXPORTS

| | Imports | | | | | | Total Adjusted | Total |
|---|---|---|---|---|---|---|---|---|
| | Adjusted Imports From ($ Mill) | | | | | | All Countries | Exports |
| Assumptions | UK | FR | GE | IT | CO | JA | Billion $ | Billion $ |
| 1. Fluorocarbons (Part of SIC 2869) | | | | | | | | |
| Fluorocarbons (DOC 1986 Import Statistics) | 20.9 | 6.3 | 3.8 | 1.0 | 1.2 | 3.6 | .04 | .05 |
| 2. Products Containing FCs | | | | | | | | |
| A/C, Refrig., Heating Equipment (use 90% of SIC 3585 to Eliminate "Heating" Part. 90% is Du Pont Estimates.) | 3.0 | 1.9 | 21.1 | 58.3 | 60.2 | 457.4 | .73 | 1.08 |
| Household Appliances (Use 10% of SIC 363, i.e., Small Regrigerators. 10% is Du Pont Estimates.) | 2.8 | 3.3 | 10.9 | 8.4 | 8.8 | 95.1 | .26 | .09 |
| SUBTOTAL 2 | 5.8 | 5.2 | 32.0 | 66.7 | 69.0 | 552.5 | .99 | 1.17 |
| 3. Products Made with FCs | | | | | | | | |
| Furnitures + Fixtures (Assume 20% of SIC 25 Contain Foam; of which 65% is Blown with FCs.) | 11.7 | 7.1 | 22.3 | 43.4 | 114.6 | 15.2 | .46 | .07 |
| Rubber & Plastic Products (Assume 1% of SIC 30 are Foamed Products, Blown with FCs.) | 2.0 | 2.0 | 3.3 | 1.6 | 9.5 | 10.1 | .05 | .03 |
| Electric Computing Equip. (Use 80% of SIC 3573.) | 134.2 | 54.1 | 102.9 | 72.6 | 282.6 | 1081.7 | 3.36 | |

|  | Imports |  |  |  |  |  | Total Adjusted All Countries Billion $ | Total Exports Billion $ |
|---|---|---|---|---|---|---|---|---|
|  | Adjusted Imports From ($ Mill) |  |  |  |  |  |  |  |
| Assumptions | UK | FR | GE | IT | CO | JA |  |  |
| 3. (cont'd) |  |  |  |  |  |  |  |  |
| Semicon. Electronic Comp. (Use 80% of SIC 3674+79.) | 142.2 | 129.7 | 188.9 | 38.9 | 385.7 | 2531.0 | 8.27 | 16.8 |
| Office Machine, Radio, & T.V., Radio Transm., Telephone & Telegraph (Use 10% of SIC 3579, 3651, 3661, 3662.) | 33.1 | 13.9 | 31.1 | 35.5 | 114.9 | 1343.0 | [illegible] | .51 |
| Motor Vehicles & Car Bodies (Use 50% of SIC 3711.) | 323.5 | 301.6 | 3333.6 | 85.5 | 7902.1 | 11275.6 | 24.50 | 4.45 |
| Motor Vehicle Parts & Access (Use 10% of SIC 3714.) | 29.1 | 24.0 | 73.2 | 11.6 | 643.0 | 158.0 | 1.13 | .83 |
| SUBTOTAL 3 | 675.8 | 532.4 | 3755.3 | 289.1 | 9452.4 | 16414.6 | 40.03 | 22.69 |

WK/JMS/RLS/rtp
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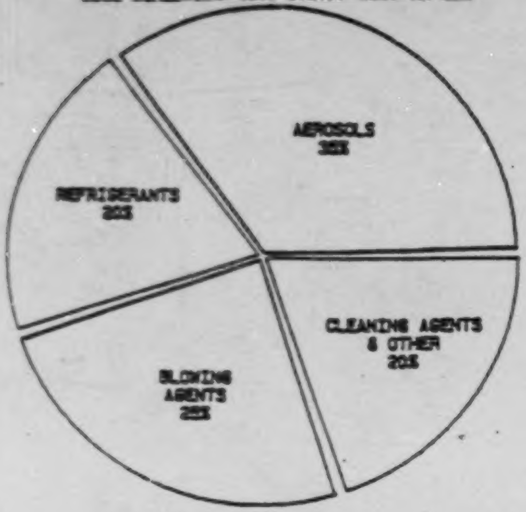
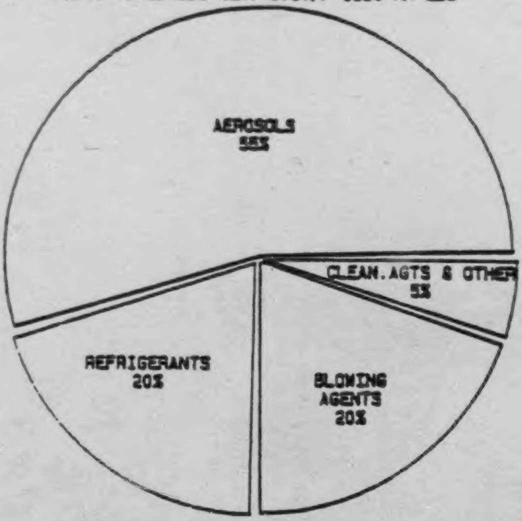
# FC-11/12/113/114/115 VOLUME BY INDUSTRY

1988 WORLDWIDE (EX. U.S.): 1250 MM LBS

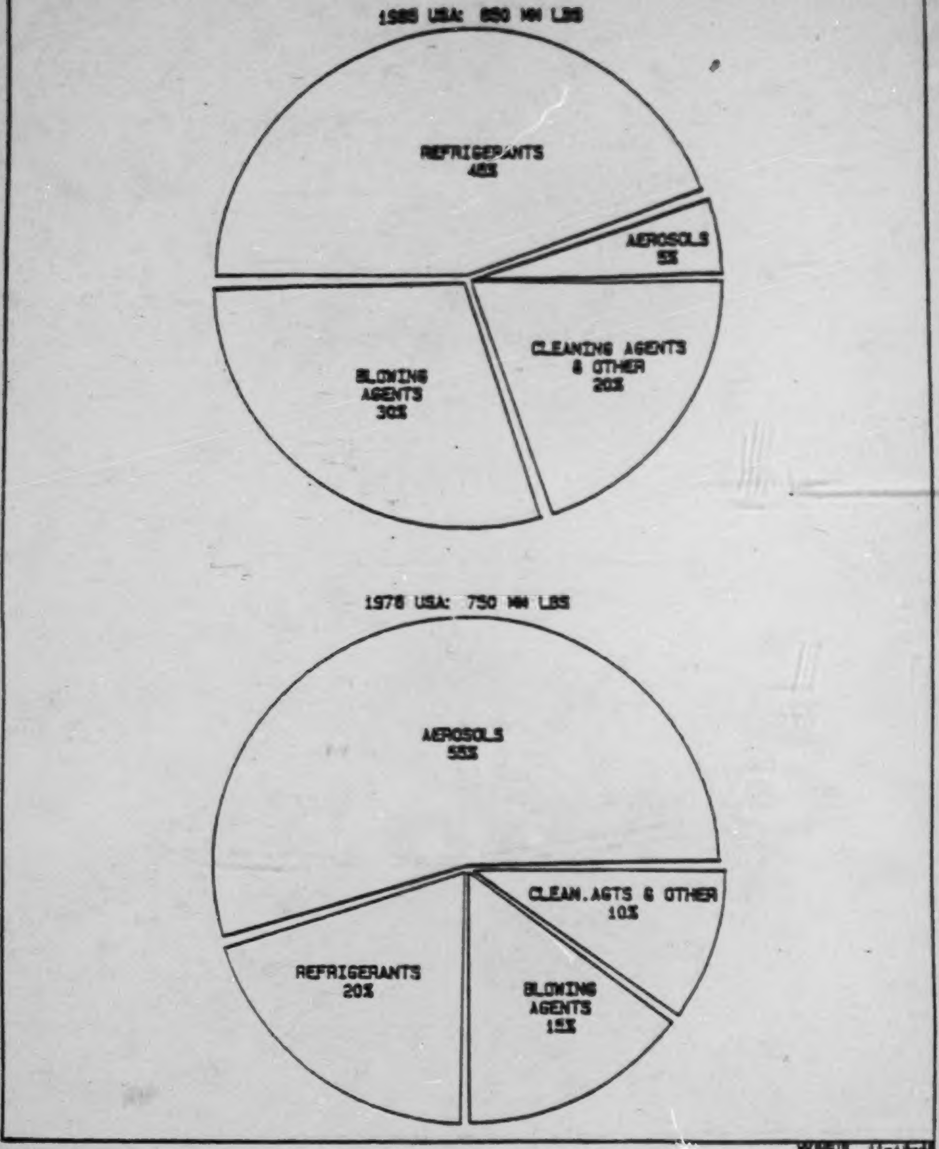


1978 WORLDWIDE (EX. U.S.): 1150 MM LBS



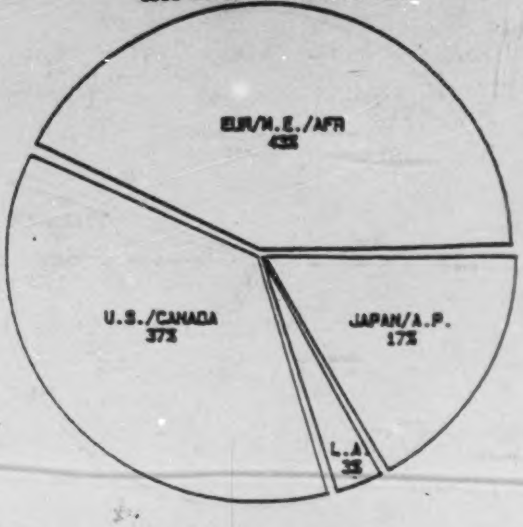
[illegible] 11-18-88

## FC-11/12/113/114/115 VOLUME BY INDUSTRY

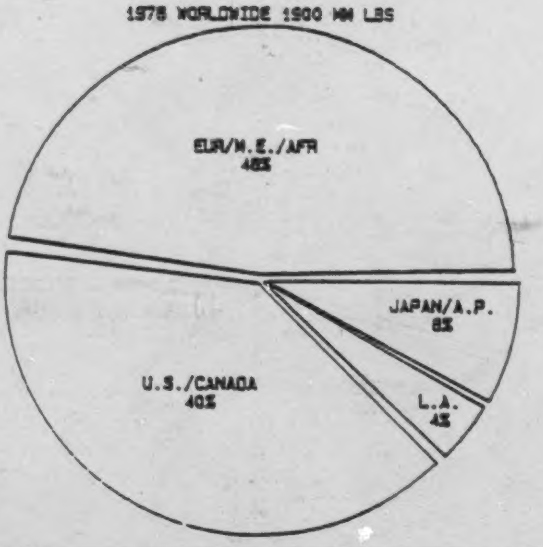


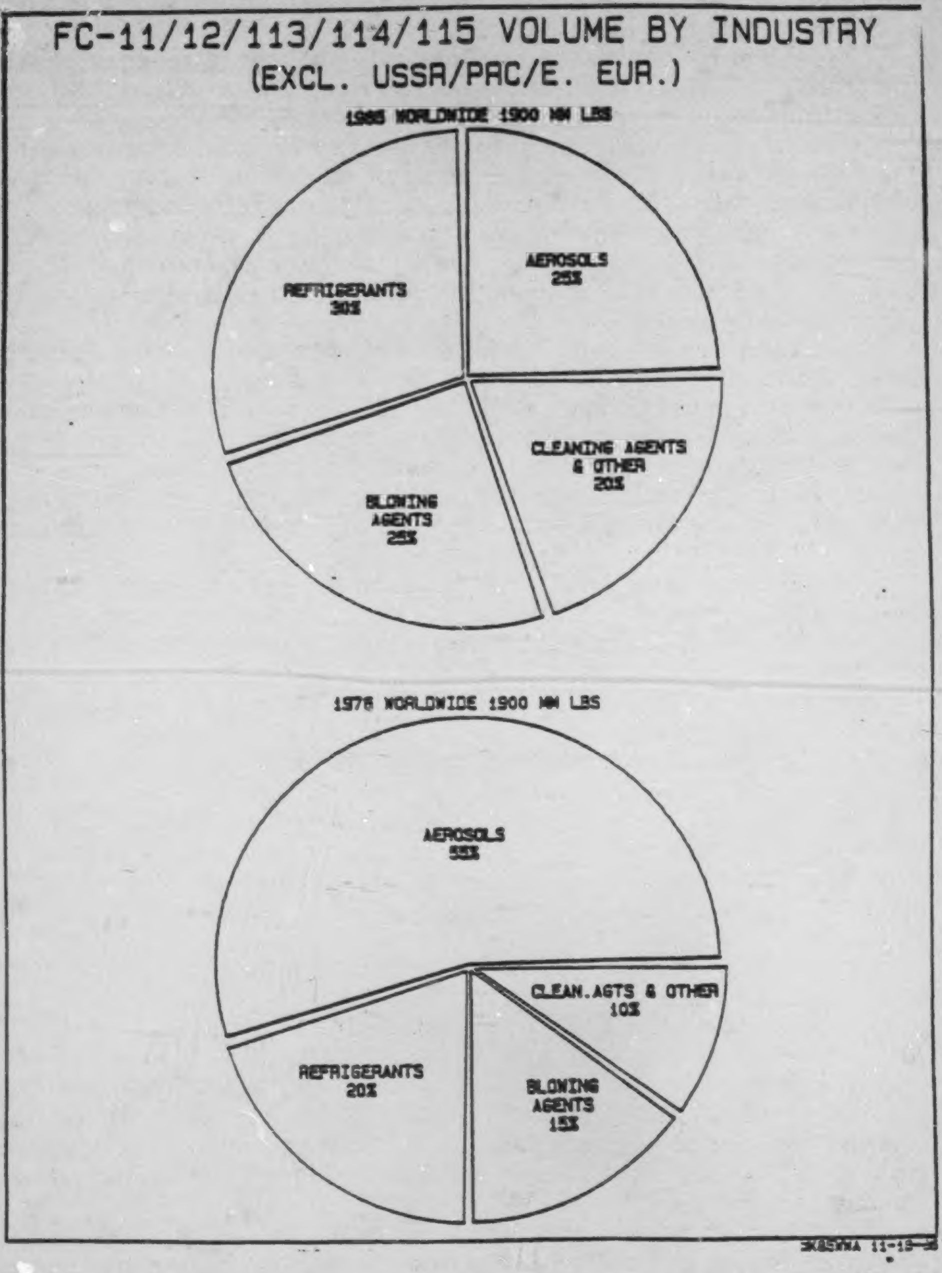
# WORLDWIDE FC-11/12/113/114/115 VOLUME BY REGION
# (EXCL. USSR/PRC/E. EUR.)

1986 WORLDWIDE 1900 MM LBS



1976 WORLDWIDE 1900 MM LBS




FC-11/12/113/114/115 VOLUME BY INDUSTRY
(EXCL. USSR/PRC/E. EUR.)
1986 WORLDWIDE 1900 MM LBS
REFRIGERANTS 30%
AEROSOLS 25%
CLEANING AGENTS & OTHER 20%
BLOWING AGENTS 25%
1976 WORLDWIDE 1900 MM LBS
AEROSOLS 55%
CLEAN.AGTS & OTHER 10%
REFRIGERANTS 20%
BLOWING AGENTS 15%
3K85YNA 11-13-86

Senator **Baucus**. Gentlemen, Senator Moynihan is unable to be here, but he has a question that he would like asked; and I will ask it of Mr. Ackell and Mr. Chisholm.

That is: There has been a fairly significant loss of revenue resulting from evasion of gasoline taxes. The question is: Why is the new collection system created by the Tax Reform Act inadequate?

Mr. **Ackell**. The reason that the new Tax Reform Act proposal is inadequate is that it places the point of collection at removal from terminals of the sort that members of my association operate.

That is midstream in the distribution process, obviously, since it has left the refinery and has gone by pipeline or by water. It has been received at a terminal facility and, once received at the facility, stored in tankage.

While the gasoline is in the tanks at the terminal, it may change ownership not at all, several times, or many times.

Our experience in New York is that without the knowledge of the terminal owner—and there is no particular reason the terminal owner should have knowledge—that "Daisy Chain," as it is called, occurred within our terminal where one of the owners in the course of the Daisy Chain, represented that the taxes had been paid.

And the belief was, from that point on, that such taxes had been paid, and it went out in the total distribution network.

Some time later, when the enforcement authorities would catch up through auditing—and that was in New York at least six months later—millions of dollars had been evaded by that distributor.

The distributor had been collapsed, couldn't be found, and the money couldn't be collected.

Now, the risks here in the Federal system of letting that gap exist between the very first point it could be taxed and, frankly, any later point opens up opportunity for creative people—as we found in many different States here, after it began in New York—to find ways to evade.

Senator **Baucus**. Mr. Chisholm, why is the system that was put in in 1986 inadequate?

Mr. **Chisholm**. Mr. Chairman, we don't believe it is inadequate; and let me first say that any system—whether it be the refinery gate, whether it be the old system, whether it be the system that is scheduled to take effect January 1—is going to be ineffective against the creative minds who want to try to evade excise taxes, unless there is much stronger enforcement by the IRS than there has been in the past.

But in response to the remarks made by Mr. Ackell, let me say that the reason the collection at the refinery gate is effect—or at the terminal is effective is because that is the common denominator.

That is where gasoline is always gasoline when it is sold, and it is taxable at that point.

At the refinery gate, more than a single product comes out of a barrel of crude oil; and there are many, many feedstocks that can be used to blend with gasoline.

And you can tax those at the refinery gate at the full nine cents a gallon, but the petrochemical users of many of those feedstocks would then be paying taxes that are not owed and would be subject to a refund.

If you don't tax them at the refinery gate, and you let the petrochemical feedstocks come to the terminal, they could at that point, or any other point in the system, be blended into gasoline; and that would have escaped taxation.

And the people who decided to do that would have a very clear competitive advantage in the process.

So, we believe the method that was created in the Tax Reform Act of 1986 will be effective, and we think it should be given a chance to work before you go to a more draconian measure just as Mr. Ackell has suggested.

Let me also point out that, from our members' standpoint, whether it is that refinery gate or whether the new law takes effect as drafted, we pay the tax to the same people. It won't matter.

Senator BAUCUS. Mr. DiBona, did you want to get in here?

Mr. DIBONA. Yes. We are very interested in this question of tax evasion because we represent many of the large oil companies, and we do pay taxes; and therefore, we do not want to have other people selling gasoline in competition with us who do not pay taxes.

We, therefore, got involved very early in the problems up in New York through our State Petroleum Council up there and have worked very closely with the New York authorities to institute changes that would minimize evasion.

With regard to this particular tax problem, last year we worked very closely with the Joint Taxation Committee staff and the IRS in developing a system to ensure that evasion would not occur.

Senator BAUCUS. There are a lot of stories about evasion: Forbes Magazine, The Wall Street Journal articles.

Mr. DIBONA. Yes.

Senator BAUCUS. I mean, it is widespread.

Mr. DIBONA. It was a problem in New York. Now, there are radically changed procedures up there.

With regard to the Federal system of collection, that has not yet changed. It won't change until the end of this year. So, it is not yet in place—the change that was made last year in the 1986 bill.

Senator BAUCUS. Isn't this really a float question?

Mr. DIBONA. Pardon?

Senator BAUCUS. Isn't this issue really a float question? Isn't that what this really comes down do?

Mr. DIBONA. Yes. What we are really talking about here is this: What you want to do is put the point collection of the tax in the first few hands, rather than a large number of hands.

In the current law that will go into effect this year, it does do that. It comes down from thousands of taxpayers to hundreds of taxpayers, so that the control of evasion is much easier.

But the most important thing is it makes roughly equal the amount of time from the payment of the tax until the sale of the product.

What Mr. Ackell is proposing is to ensure that his members pay the tax very close to the point of final sale to consumers while others are forced to pay at great distance and therefore a great time lapse.

Therefore, his competitors would be required to fund this tax during the period of time between the payment of the tax and the sale to the consumer.

That means the price will have to rise for the competitors.

Now, some of that will be borne by the large refiner who have this long distance of transit and this long period of funding the payment of this tax; but some of it will be borne by the consumer.

Senator BAUCUS. Thank you, gentlemen, very much. I am afraid we are going to have to conclude the hearing at this point. Thank you very much. We appreciate your testimony.

The hearing is adjourned.

[Whereupon, at 12:32 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

# APPENDIX

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AOPA
AIRCRAFT OWNERS & PILOTS ASSOCIATION
421 Aviation Way, Frederick Airport, Frederick, MD 21701, Telephone (301) 695-2000/Telex 89-3445

STATEMENT OF JOHN L. BAKER
PRESIDENT
AIRCRAFT OWNERS AND PILOTS ASSOCIATION
On Federal Tax Revenue Options for 1987
COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 16, 1987

Mr. Chairman, on behalf of the 260,000 pilot members of the Aircraft Owners and Pilots Association, I appreciate this opportunity to submit a statement regarding the aviation tax proposals contained in the Joint Committee on Taxation report, Description of Possible Options to Increase Revenues.

While we understand and appreciate the tough job this committee has in developing new revenues, increasing the federal tax burden on aviation at this time would be counterproductive to congressional revenue efforts and possibly lethal to American general aviation.

I would like to address three proposals of great concern to pilots: 1) imposition of a ten percent "luxury" sales tax on new general aviation aircraft; 2) addition of a ten-cent per gallon excise tax to aviation fuel; 3) increasing trust fund excise taxes by 33 percent. Each proposal individually has a negative impact on aviation, particularly the "luxury" tax. Taken together, the excise fuel tax proposals alone would increase general aviation's federal tax burden by a crushing 133 percent!

Aviation users are already paying twelve and fourteen cents per gallon into the federal Airport and Airway Trust Fund to support the capital development and modernization of the national airspace system. This totally user-supported fund consistently runs at a surplus with over $5 billion in unobligated funds anticipated at the end of this year. Increasing the excise tax levels in face of these massive trust fund surpluses is simply unfair and unconscionable.

The net effect of these revenue actions is to penalize both the aircraft ownership and operation of general aviation. The sales tax proposal will severely damage a uniquely American industry which is far from robust.

Once the world leader, the domestic general aviation industry has fallen on hard times, with only 1,495 new aircraft delivered in 1986, the fewest since World War II. In contrast, foreign manufacturers including France, Brazil, Great Britain, and Italy threaten to take over the American general aviation market.

The Joint Committee must recognize the basic contributions made by general aviation aircraft to national productivity and balance of trade. Only by maximizing the ability of American commerce to compete, both at home and abroad, will substantial progress be made to resolve the twin national dilemmas of the trade imbalance and federal deficit.

To the vast majority of aviation operators, an airplane is essential to business activities in much the same manner as the truck and automobile. These vehicles enable businesses to transport goods and personnel efficiently and conveniently to areas not covered by scheduled air transportation. Business uses of general aviation include air ambulance, reconnaissance, mapping and energy exploration, agricultural applications, mail and parcel delivery service, as well as flight training. Classifying general aviation aircraft as "luxury" items totally misrepresents the use and purpose of these airplanes.

Over the past seven-year period, general aviation flight activity has declined more than twenty percent. The number of pilots in this nation has been reduced by almost 120,000 pilots over the same period. Under today's deregulated aviation industry, the demand for trained pilots has exploded. The Future Airline Professionals of America (FAPA) predicts that the commercial airline industry will need an additional 42,000 new airline pilots to meet the demand. The United States military, a traditional source of trained pilots for commercial airlines, is supplying fewer pilots to the civilian marketplace. Today more and more pilots are trained and gain experience through general aviation.

The additional burden imposed by more federal fuel taxes penalizes the use of general aviation, including necessary training operations. The fuel tax would add more expense to the already skyrocketing operations and aviation liability costs. This will ultimately result in depressing general aviation activity further, limiting the amount of federal revenues generated.

We respectfully request this committee to block these ill-conceived and counterproductive general aviation tax proposals.

##

## TESTIMONY SUBMITTED

by the

## AMERICAN ARTS ALLIANCE

The American Arts Alliance is pleased to submit testimony to the Senate Finance Committee in connection with the Committee's hearings on possible revenue-raising options.

The Alliance, established in 1977, is a consortium of over 350 member nonprofit arts institutions that are active in the fields of theater, dance, opera, symphony orchestras, and the visual arts. Central to the Alliance's purpose is the establishment of a national public policy for the arts.

The Alliance welcomes the opportunity to participate in these hearings and supports the Committee's efforts to examine a wide-variety of revenue-raising options. While the Alliance is well aware of the need to lower the federal deficit, it is concerned that several of the revenue-raising proposals, following as they do on the heels of last year's tax reform, would further impair its members' important cultural missions. The proposals that chiefly concern the Alliance are (1) the five percent excise tax on net investment income of all tax-exempt organizations, and (2) those affecting the itemized deductions and the alternative minimum tax rate that would diminish the tax incentives for charitable contributions.

The proposal that a five percent excise tax be imposed on the net investment income, including the endowment, pension, and investment monies, of all tax-exempt organizations is particularly troublesome. Such a change in federal tax law would reduce the funds available for the conduct of tax-exempt arts and other cultural activities. This suggested means of raising revenue runs directly contrary to the premises upon which the long-standing federal policy of exempting certain organizations from taxation is based. This policy reflects a very early recognition on the part of our federal government that certain activities and services, many of which are carried out by volunteers, are so beneficial to the general public that they should be encouraged. The members of the Alliance, for example, enrich the lives of our citizens, including those who might not otherwise be able to avail themselves of the arts, by providing exhibitions and performances in local communities.

Further, to tax endowments would be counter to policies being advanced by the National Endowment for the Arts, which, through its challenge grant program, encourages the development of endowments as a means of developing long-term stability for arts organizations. Tax policy ought not to clash with these arts programs' policy objectives.

Endowments, which generate investment income, are a way of providing financial security for arts organizations the financial base of which is otherwise often precarious at best. Not only do they help to fund institutional operations, but they also permit an organization to undertake additional educational programs which otherwise would not be possible from any other source of financing. As just one example, the Boston Ballet has an educational endowment that helps to support its South End Community Dance Project. This project involves working with minority youth to teach jazz, African, modern, and Spanish dance. The existence of an investment income generating endowment also allows such organizations to plan projects for the future or to fund long-term cultural activities with the comfort that the funds will be there. Amounts raised annually from contributions and grants cannot be a substitute for an arts organization being able to plan a budget that allows it full utilization of its investment income.

To enact a measure that would reduce the available funds from what is often the most viable way of financing such worthwhile arts projects would risk substantially a reduction of the development and scope of the projects themselves. This result would be particularly unfortunate, as this particular revenue-raising proposal is not associated with any form of perceived abuse by tax-exempt organizations.

The Alliance understands the need for all organizations to participate in the process of reducing the federal budget deficits. However, reductions in federal spending and law changes wrought by the 1986 tax reforms have already caused arts organizations to participate in that process far beyond its equitable share. The proposed revenue-raising options would serve to unfairly increase this unwarranted burden.

Equally threatening to nonprofit arts organizations are the varied suggestions that would erode the incentive of individuals to continue making charitable contributions, including property that has appreciated in value. Specifically, these suggestions include:

- allowing itemized deductions for individuals only against the 15 percent tax rate, rather than the 28 percent tax rate.
- creating a new floor equal to 10 percent of an individual's adjusted gross income in excess of $100,000 ($50,000 for a single individual) under the total amount of a taxpayer's allowed itemized deductions.
- increasing the alternative minimum tax rate from 21 percent to 25 percent.

Each of these proposals would act as a disincentive for individual taxpayers to make the contributions that fuel considerably our country's nonprofit public-service sector. Combined with provisions in the Tax Reform Act of 1986, they would further undermine the ability of nonprofit arts institutions to continue to provide services to the public. These proposals would also run contrary to certain long-standing federal tax policies and practices. The creation of the floor for itemized deductions, for example, is contrary to the tradition of tax comity with state and local governments, and would surely cause a meaningful shrinkage in charitable giving.

The Alliance recognizes that people do not contribute to nonprofit organizations solely because of tax incentives. However, it is undeniable that such incentives affect the amount of contributions. After last year's loss of the nonitemizer's deduction and the inclusion of appreciated property in the alternative minimum tax, nonprofit arts institutions are particularly vulnerable. It is certainly disheartening that, in a climate that is currently scrutinizing the income-raising activities of the nonprofit sector, there would also be consideration of measures that would reduce substantially the most traditional and well-accepted means for charities to raise funds to support these exempt activities.

In summary, the Alliance believes that the five percent excise tax and the disincentives for charitable giving should be eliminated from the list of revenue-enhancing proposals that the Senate Finance Committee is considering. The invaluable societal objectives that gave rise to the incentives for engaging in and contributing to certain prescribed activities, such as the promotion of the arts, continue to be compelling for the development of our citizens. Many of the organizations engaged in these activities may not be able to withstand further attacks on their financial base.

## TESTIMONY OF

## JOHN ARCHER

## MANAGING DIRECTOR, GOVERNMENT AFFAIRS

## AMERICAN AUTOMOBILE ASSOCIATION

Mr. Chairman, members of the committee, I am pleased to be here today. I am John Archer, managing director of Government Affairs for the American Automobile Association.

AAA is a federation of automobile clubs serving more than 27.7 million dues-paying members. AAA's members purchase nearly 20 percent of the 100 billion gallons of gasoline sold annually. For this and other reasons, AAA is strongly opposed to proposals to impose a new federal tax on gasoline or oil to reduce the federal deficit. Singling out the motorist to balance the budget at the gas pump is not only unfair but unwise.

### The American People Strongly Oppose A Gasoline Tax Increase

The American people oppose a federal gas tax increase for deficit reduction, as indicated by the latest *Washington Post*-ABC News Poll, conducted June 25 to June 29. The nationwide telephone poll of 1,506 people found that 73 percent of those polled disapprove of raising taxes on gasoline to balance the federal budget (27 percent approved).

### Negative Economic Impact

Because of the continuing legislative interest in further taxing gasoline, AAA recently commissioned Wharton Econometric Forecasting Associates to study the economic impacts of major excise tax proposals.

The study concluded that the near-term costs of such a gasoline tax are exceedingly negative. Thousands of people would be put out of work, consumer prices in general would rise, and the poor would be hurt disproportionately. People who come from the South and West--many of whom have already suffered from the recent downturn in oil prices--on average must travel greater distances by personal vehicles and therefore pay even more of this tax.

Specifically, the study found that adding 10 cents to the cost of a gallon of gasoline would produce the following negative economic impacts:

- The Gross National Product would be reduced by nearly $10 billion in the first year alone;
- Automobile production would fall by 1.3 percent;
- Housing construction would drop 0.9 percent;
- 80,000 persons would be out of work next year;
- 180,000 would be out of work by 1990;
- Petroleum refinery output would decline by 1.2 percent;
- Income tax revenues would decline by nearly $1 billion annually;
- Personal savings would decline by nearly 3 percent;
- The Consumer Price Index would rise by 0.3 percent.

Adding 30 cents more to the cost of gasoline--as would one legislative proposal--would virtually triple these consequences. Most important is the study's finding that 225,000 persons would be put out of work next year and 525,000 would be out of work by 1990.

The study found the following secondary impacts worthy of note:

- Welfare payments by government agencies for unemployment and food stamps would increase;

-- Payments of U.S. industries for wages and salaries would fall, multiplying the impact on national income.

The study is included with this testimony, along with a letter to Representative Glenn Anderson, Chairman of the House Surface Transportation Subcommittee, wherein Dr. Mark French, the author of the study, further discusses the conclusions of his study, along with other possible options he chose to examine.

The highly negative economic effects of a new federal excise tax on gasoline also were emphasized in the Energy Department's recent Energy Security report. That report states that a new gasoline tax would be inflationary, discriminate against low income groups, reduce tax revenues in other categories, and increase unemployment. It concluded that a gasoline tax "is not a cost effective way to increase energy security," and that the "macroeconomic loss is estimated to (be) over 100 times as high as the estimated energy security benefits."

Income Distortions

A gasoline tax increase for deficit reduction would place an undue burden on lower income families. According to the U.S. Census Bureau, nearly 78 percent of Americans earning less than $10,000 drive to work. Families that earn less than $5,000 annually pay nearly 8 times more of their available income in gasoline taxes than those families earning in excess of $50,000 (see Exhibit I). According to the Congressional Budget Office, the lower income group pays more than 1.6 percent of their income to gasoline excise taxes, while the high income group pays only 0.2 percent of their income.

This large gap in tax apportionment demonstrates the very substantial burden gasoline taxes have on the poor. An increase in this tax would seriously exacerbate this regressive effect.

Of course, traditional gasoline taxes to fund highway construction are also regressive (and have differing regional impacts), but they are justifiable on a user fee basis. The more you drive and therefore derive benefit from the nation's road structure, the more you pay--what could be fairer than that? However, this justification collapses completely for a gasoline tax not earmarked for economically beneficial road construction or rehabilitation.

Moreover, even a minor increase in gasoline taxes would counteract the tax benefits derived by the working poor from the Tax Reform Act of 1986. Calculations by Peat Marwick Main & Co. indicate that the 1986 Tax Reform Act provided $414 million in tax reduction for income groups earning less than $10,000 annually. However, a 1-cent gasoline tax increase would reduce this benefit by $99 million, and a 4-cent increase would largely negate this benefit, while a 12-cent gasoline tax would triple the harm to this low-income group.

We cannot believe that many members of Congress want to hit the working poor with a huge tax burden less than a year after approving the tax reform law that was touted as removing them entirely from the federal tax rolls. Such an abrupt turnaround would be unfair.

Geographic Distortions

Consumers in some parts of the nation would bear a disproportionate brunt of any increase in gasoline tax payments. For example, in the eastern United States, consumers use much less gasoline than must their counterparts in western and many southern states. A comparison of the average annual fuel consumption per licensed driver in the District of Columbia (394 gallons), New York (568 gallons), and Rhode Island (574 gallons) with that of Wyoming (882 gallons), Tennessee (788 gallons), or Oklahoma (754 gallons), provides an indication of the vast differences in distances traveled and gasoline purchased from region to region (see Exhibit II).

Why should a resident of Wyoming pay more than twice as much as a resident of the District of Columbia to cut the federal deficit solely because the person from Wyoming must drive longer distances? In both cases, the money raised would be diverted to non-highway purposes. So drivers in all of these areas would gain no direct benefit from the new tax. The table attached to this testimony (Exhibit III) shows how the various tax proposals would affect motorists in each of the states.

## Jeopardizing Highways

The imposition of a federal gasoline tax for deficit reduction also threatens the future ability of states to raise user fuel taxes for road construction and repair.

All but one cent of the current 9-cent federal excise tax on gasoline is dedicated to building and improving the nation's federal/state highway system. This system is the envy of the world, as is the mechanism that has been used to finance it.

To tax gasoline for non-highway purposes would seriously erode the public's support for the successful pay-as-you-go federal/state highway program. It would severely hamper the ability of states to raise their own motor fuel taxes to match federal dollars, as well as jeopardize public support for strictly local projects.

To meet burgeoning highway needs, eight states have raised fuel taxes this year, and 14 more are considering doing so. But state legislators would be hard pressed to justify further increases in their transportation-related taxes if their federal counterparts usurp this role. If that happens, the federal government could quickly find itself obligated to bear the cost of all future transportation projects because states would be unable or unwilling to do so.

## A Low Blow to Tourism

It is painfully ironic that only weeks after the country celebrated National Tourism Week, Congress is seriously considering a major new gasoline tax which could have severe consequences for the tourism industry. After all, approximately 80 percent of vacation travel in the U.S. is conducted by private vehicles which would have to pay such a tax.

National Tourism Week's slogan--Tourism Works for America--is a clear statement about its enormous contribution to the U.S. economy.

Tourism is one of the top three employers in 80 percent of the states. Auto travel, including by car, truck, RV, and motorcycle, represents the primary mode of transportation for all travel away from home in the U.S. According to The 1986-87 Economic Review of Travel in America, published by the U.S. Travel Data Center, "(P)ersonal motor vehicle travel is particularly sensitive to...rapid price inflation." Wide fluctuations in gasoline prices, whether caused by turmoil in the Persian Gulf or by federal tax policy, would have a major impact on vehicle travel and tourism in general.

In Wharton's study on the effects of gasoline taxes, it found that "...every one percent increase in real gasoline price drives down simulated car travel by one-half of a percent. In addition, changes in real income also affect simulated miles traveled. Together, these price and income effects reduced simulated 1988 miles traveled per vehicle by just under 3 percent with a 10-cent tax increase. The fall was closer to 8 percent with a 30-cent tax rise."

Unfortunately, a 30-cent tax hike may be a real possibility over the next three-year budget cycle if a gasoline tax increase is enacted this year. The budget committees have concluded that they need more than 60 billion dollars in new taxes in the next three years. Thus the 10-cent gas tax increase now being considered could even become only a first installment on future increases, if the precedent is established to use gasoline taxes to fund the deficit.

With another rising trend in the cost of oil, the last thing the American public needs is a federal gasoline tax increase, let alone several such tax increases over the next few years.

## Revenue Increase Options

Of course, there are other ways to raise revenues instead of raising the excise tax on gasoline. We believe that at least two revenue enhancers in the motor fuels area should be seriously examined.

The first is the possible elimination of the gasohol exemption from the federal gasoline tax. A vehicle using gasohol is presently exempted from 6-cents of the 9-cents-per-gallon federal gasoline tax. The Federal Highway Administration estimates that the federal gasohol tax exemption will result in a loss to the federal government of some $450 million in 1987 and in four years will represent a loss of more than $500 million annually. This exemption violates the basic tenet of highway finance; namely that if you use the roads, you should pay your fair share of road construction and repair.

If the committee feels ethanol should continue to be subsidized, that objective could be accomplished by eliminating the exemption but retaining the blender tax credit of 60-cents-per-gallon of alcohol. The tax credit to subsidize ethanol producers could be limited to a maximum amount per producer. Termination of the exemption and modification of the credit would reduce the cost of alcohol subsidies, end current subsidies to foreign production, reduce the size of the subsidies now given to a few large domestic producers, but at the same time continue a 60-cent-per-gallon subsidy for small ethanol blenders. Large domestic producers and alcohol importers, which are the principal (although indirect) recipients of the tax benefits of the gasohol exemption, hardly fall into the category of struggling U.S. small businesses attempting to gain U.S. energy independence.

Presently, according to FHWA, government subsidies for gasohol exceed the selling price of the product by approximately 15 percent. Under the current subsidy structure this industry no longer makes economic sense. Encouraging inefficient producers by oversubsidizing their product only ensures greater U.S. tax revenue losses in the future.

Another area that should be considered is diesel fuel tax evasion. The Federal Highway Administration estimates that the loss to the federal government could be in the neighborhood of $500 million annually. According to FHWA, "there is ample evidence that widespread evasion of payment of the diesel motor fuel taxes is continuing..."

It is time that this callous disregard for paying necessary federal excise taxes be stopped. This money is owed to the federal government and it should be paid and collected. Simply by moving the point of tax incidence and collection from the fuel pump to the jobber or distributor level could reduce the number of tax collection points by tens of thousands. This remedy could help pinpoint tax responsibility and reduce the number of tax audits needed to verify tax collection.

Evasion of diesel tax is not a new issue. The Ways and Means hearing on "Alternatives to the Heavy Vehicle Use Tax" on February 23, 1984, "...identified two major areas in which evasion can...occur." First "...substitution of home heating oil for diesel fuel, thereby avoiding the tax increase." Second, "...exemptions for agricultural uses of diesel...offers another major potential for evasion."

That 1984 hearing [p. 134 "Alternatives to the Heavy Vehicle Use Tax" Hearing before the Committee on Ways and Means, House of Representatives, Serial 98-65, Feb. 1984.] also cites the significant enhancement of revenue collections in Canada by "...adding color to fuel in order to demonstrate the difference between fuel which was eligible for diesel over-the-road trucks, as distinct from other kinds of diesel fuel uses." In fact, in that hearing a state official testified of personal knowledge of a common practice of substituting No. 2 diesel (home heating oil) for No. 1 diesel fuel during the warm weather months.

Before even considering an increase in federal fuel taxes, the government should ensure that all taxes imposed are collected. Simply raising taxes makes illegal activities even more profitable.

Thank you again for listening to our concerns.

JA/lb

Exhibit I

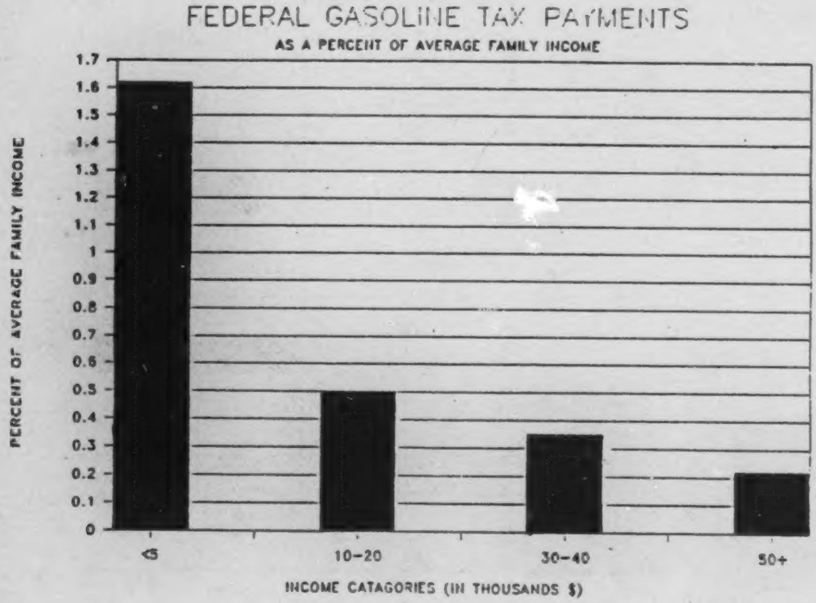
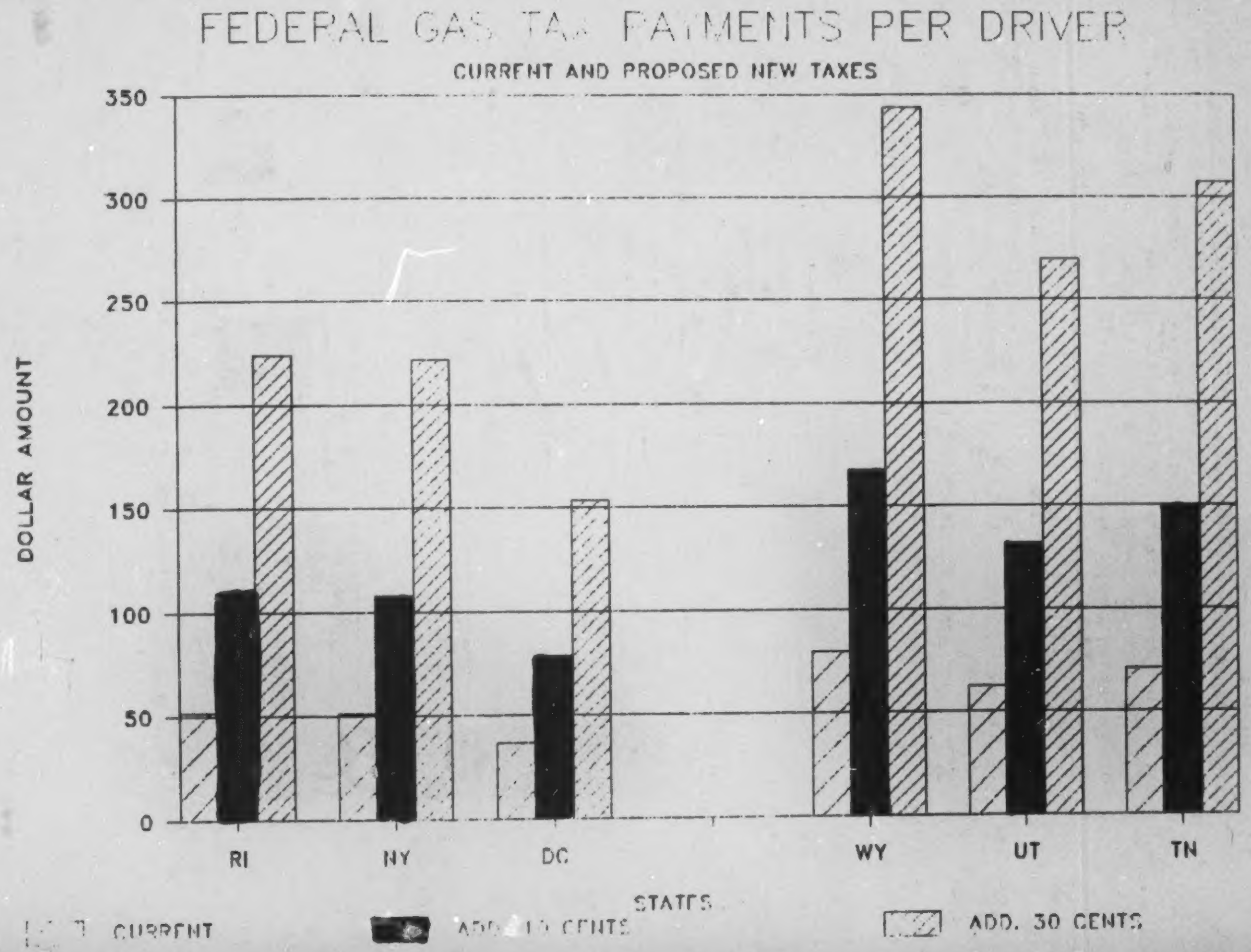


Exhibit II


FEDERAL GAS TAX PAYMENTS PER DRIVER
CURRENT AND PROPOSED NEW TAXES
DOLLAR AMOUNT
350
300
250
200
150
100
50
0
RI
NY
DC
WY
UT
TN
STATES
CURRENT
ADD. 10 CENTS
ADD. 30 CENTS

ANALYSIS OF PROPOSED FEDERAL TAXES ON GASOLINE FOR DEFICIT REDUCTION
BASED ON 1985 GASOLINE USAGE AND LICENSING DATA (1)
PREPARED BY AMERICAN AUTOMOBILE ASSOCIATION, GOVT. AFFAIRS

| STATE | TOTAL LICENSED DRIVERS | ANNUAL GASOLINE USE(2) | ANNUAL GAS USE (3) PER DRIVER | TOTAL STATE GAS TAX | TOTAL STATE & FED. TAX | TOTAL W/ 9 CENTS ADDED | DIFFER. | TOTAL W/ 10 CENTS ADDED | DIFFER. | TOTAL W/ 12 CENTS ADDED | DIFFER. | TOTAL W/ 30 CENTS ADDED | DIFFER. | STATE |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| AL | 2,461,559 | 1,773,542 | 720 | $93.66 | $158.51 | $223.35 | $64.84 | $230.56 | $72.05 | $244.97 | $86.46 | $374.66 | $216.15 | AL |
| AK | 300,000 | 203,199 | 677 | 54.19 | 115.15 | 176.11 | 60.96 | 182.88 | 67.73 | 196.43 | 81.28 | 318.35 | 203.20 | AK |
| AZ | 2,324,591 | 1,495,801 | 643 | 102.95 | 160.87 | 218.78 | 57.91 | 225.21 | 64.35 | 238.08 | 77.22 | 353.91 | 193.04 | AZ |
| AR | 1,723,753 | 1,067,133 | 619 | 83.56 | 139.29 | 195.01 | 55.72 | 201.20 | 61.91 | 213.58 | 74.29 | 325.01 | 185.72 | AR |
| CA | 17,444,640 | 10,971,711 | 629 | 56.61 | 113.21 | 169.82 | 56.61 | 176.10 | 62.89 | 188.68 | 75.47 | 301.89 | 188.68 | CA |
| CO | 2,284,364 | 1,471,483 | 644 | 115.95 | 173.92 | 231.90 | 57.97 | 238.34 | 64.42 | 251.22 | 77.30 | 367.17 | 193.25 | CO |
| CT | 2,314,612 | 1,288,240 | 556 | 94.47 | 144.48 | 194.50 | 50.01 | 200.05 | 55.57 | 211.17 | 66.68 | 311.19 | 166.71 | CT |
| DE | 447,937 | 309,601 | 691 | 89.85 | 152.06 | 214.26 | 62.21 | 221.17 | 69.12 | 235.00 | 82.94 | 359.41 | 207.35 | DE |
| DC | 384,738 | 151,441 | 394 | 61.01 | 96.44 | 131.88 | 35.43 | 135.80 | 39.36 | 143.67 | 47.23 | 214.52 | 118.09 | DC |
| FL | 8,016,239 | 4,982,050 | 621 | 60.28 | 116.22 | 172.15 | 55.93 | 178.37 | 62.15 | 190.80 | 74.58 | 302.67 | 186.45 | FL |
| GA | 3,910,454 | 3,000,005 | 767 | 57.54 | 126.58 | 195.63 | 69.05 | 203.30 | 76.72 | 218.65 | 92.06 | 356.74 | 230.15 | GA |
| HI | 593,952 | 310,131 | 522 | 57.44 | 104.43 | 151.42 | 46.99 | 156.64 | 52.21 | 167.09 | 62.66 | 261.07 | 156.64 | HI |
| ID | 692,404 | 405,120 | 585 | 84.84 | 137.50 | 190.16 | 52.66 | 196.01 | 58.51 | 207.71 | 70.21 | 313.03 | 175.53 | ID |
| IL | 6,949,622 | 4,594,229 | 661 | 85.94 | 145.44 | 204.93 | 59.50 | 211.54 | 66.11 | 224.77 | 79.33 | 343.76 | 198.32 | IL |
| IN | 3,597,585 | 2,377,364 | 661 | 92.52 | 151.99 | 211.46 | 59.47 | 218.07 | 66.08 | 231.29 | 79.30 | 350.24 | 198.25 | IN |
| IA | 1,900,998 | 1,225,615 | 645 | 103.16 | 161.18 | 219.21 | 58.02 | 225.65 | 64.47 | 238.55 | 77.37 | 354.60 | 193.42 | IA |
| KS | 1,655,820 | 1,131,990 | 684 | 75.20 | 136.73 | 198.26 | 61.53 | 205.09 | 68.36 | 218.77 | 82.04 | 341.82 | 205.09 | KS |
| KY | 2,248,361 | 1,602,540 | 713 | 106.91 | 171.06 | 235.21 | 64.15 | 242.34 | 71.28 | 256.59 | 85.53 | 384.89 | 213.83 | KY |
| LA | 2,755,943 | 1,983,728 | 720 | 115.17 | 179.95 | 244.73 | 64.78 | 251.93 | 71.98 | 266.33 | 86.38 | 395.89 | 215.94 | LA |
| ME | 803,830 | 498,411 | 620 | 86.81 | 142.61 | 198.41 | 55.80 | 204.61 | 62.00 | 217.02 | 74.41 | 328.62 | 186.01 | ME |
| MD | 2,907,494 | 1,914,815 | 659 | 121.84 | 181.11 | 240.38 | 59.27 | 246.97 | 65.86 | 260.14 | 79.03 | 378.68 | 197.57 | MD |
| MA | 3,792,074 | 2,271,738 | 599 | 65.90 | 119.82 | 173.73 | 53.92 | 179.72 | 59.91 | 191.70 | 71.89 | 299.54 | 179.72 | MA |
| MI | 6,254,118 | 3,791,074 | 606 | 90.93 | 145.48 | 200.04 | 54.56 | 206.10 | 60.62 | 218.22 | 72.74 | 327.33 | 181.85 | MI |
| MN | 2,473,073 | 1,777,842 | 719 | 122.19 | 186.88 | 251.57 | 64.69 | 258.75 | 71.88 | 273.13 | 86.25 | 402.50 | 215.63 | MN |
| MS | 1,810,847 | 1,115,067 | 616 | 55.42 | 110.84 | 166.26 | 55.42 | 172.42 | 61.58 | 184.73 | 73.89 | 295.57 | 184.73 | MS |
| MO | 3,393,353 | 2,472,657 | 729 | 51.01 | 116.59 | 182.17 | 65.58 | 189.46 | 72.87 | 204.03 | 87.44 | 335.19 | 218.60 | MO |
| MT | 582,085 | 391,164 | 672 | 114.24 | 174.72 | 235.20 | 60.48 | 241.92 | 67.20 | 255.36 | 80.64 | 376.32 | 201.60 | MT |
| NE | 1,089,797 | 670,067 | 615 | 105.14 | 160.48 | 215.81 | 55.34 | 221.96 | 61.49 | 234.26 | 73.78 | 344.93 | 184.46 | NE |
| NV | 699,077 | 473,968 | 678 | 88.14 | 149.16 | 210.18 | 61.02 | 216.96 | 67.80 | 230.52 | 81.36 | 352.56 | 203.40 | NV |
| NH | 737,852 | 427,668 | 580 | 81.15 | 133.31 | 185.48 | 52.17 | 191.27 | 57.96 | 202.86 | 69.55 | 307.19 | 173.88 | NH |
| NJ | 5,793,689 | 3,078,522 | 531 | 42.51 | 90.33 | 138.15 | 47.82 | 143.47 | 53.14 | 154.09 | 63.76 | 249.74 | 159.41 | NJ |
| NM | 977,880 | 726,590 | 743 | 81.73 | 148.61 | 215.48 | 66.87 | 222.91 | 74.30 | 237.77 | 89.16 | 371.51 | 222.91 | NM |
| NY | 9,841,209 | 5,588,336 | 568 | 45.43 | 96.53 | 147.64 | 51.11 | 153.32 | 56.79 | 164.68 | 68.14 | 266.89 | 170.36 | NY |
| NC | 4,122,866 | 2,864,697 | 695 | 109.44 | 171.97 | 234.51 | 62.53 | 241.45 | 69.48 | 255.35 | 83.38 | 380.42 | 208.45 | NC |
| ND | 443,002 | 318,010 | 718 | 93.32 | 157.93 | 222.53 | 64.61 | 229.71 | 71.79 | 244.07 | 86.14 | 373.28 | 215.36 | ND |
| OH | 7,336,386 | 4,497,933 | 613 | 73.57 | 128.75 | 183.93 | 55.18 | 190.06 | 61.31 | 202.32 | 73.57 | 312.68 | 183.93 | OH |
| OK | 2,243,223 | 1,690,761 | 754 | 75.37 | 143.21 | 211.04 | 67.83 | 218.58 | 75.37 | 233.65 | 90.45 | 369.32 | 226.12 | OK |
| OR | 1,959,765 | 1,170,229 | 597 | 65.68 | 119.43 | 173.17 | 53.74 | 179.14 | 59.71 | 191.08 | 71.66 | 298.56 | 179.14 | OR |
| PA | 7,555,006 | 4,226,959 | 559 | 67.14 | 117.49 | 167.85 | 50.35 | 173.44 | 55.95 | 184.63 | 67.14 | 285.34 | 167.85 | PA |
| RI | 619,132 | 355,100 | 574 | 86.03 | 137.65 | 189.27 | 51.62 | 195.01 | 57.35 | 206.48 | 68.83 | 309.71 | 172.06 | RI |
| SC | 2,131,895 | 1,523,368 | 715 | 92.89 | 157.20 | 221.51 | 64.31 | 228.66 | 71.46 | 242.95 | 85.75 | 371.57 | 214.37 | SC |
| SD | 483,890 | 351,627 | 727 | 94.47 | 159.87 | 225.27 | 65.40 | 232.53 | 72.67 | 247.07 | 87.20 | 377.87 | 218.00 | SD |
| TN | 3,025,458 | 2,384,524 | 788 | 133.99 | 204.92 | 275.85 | 70.93 | 283.74 | 78.82 | 299.50 | 94.58 | 441.37 | 236.45 | TN |
| TX | 10,809,078 | 8,211,043 | 760 | 75.96 | 144.33 | 212.70 | 68.37 | 220.30 | 75.96 | 235.49 | 91.16 | 372.23 | 227.89 | TX |
| UT | 962,881 | 666,104 | 692 | 96.85 | 159.11 | 221.37 | 62.26 | 228.29 | 69.18 | 242.12 | 83.01 | 366.64 | 207.53 | UT |
| VT | 385,132 | 232,098 | 603 | 78.34 | 132.58 | 186.82 | 54.24 | 192.85 | 60.26 | 204.90 | 72.32 | 313.38 | 180.79 | VT |
| VA | 3,804,113 | 2,584,583 | 679 | 118.90 | 180.05 | 241.19 | 61.15 | 247.99 | 67.94 | 261.58 | 81.53 | 383.87 | 203.83 | VA |
| WA | 2,980,717 | 1,769,908 | 594 | 106.88 | 160.32 | 213.76 | 53.44 | 219.70 | 59.38 | 231.58 | 71.25 | 338.46 | 178.14 | WA |
| WV | 1,298,585 | 728,722 | 561 | 86.14 | 136.64 | 187.15 | 50.50 | 192.76 | 56.12 | 203.98 | 67.34 | 304.99 | 168.35 | WV |
| WI | 3,211,330 | 1,871,440 | 583 | 101.98 | 154.43 | 206.88 | 52.45 | 212.71 | 58.28 | 224.36 | 69.93 | 329.26 | 174.83 | WI |
| WY | 331,850 | 292,631 | 882 | 70.55 | 149.91 | 229.27 | 79.36 | 238.09 | 88.18 | 255.73 | 105.82 | 414.45 | 264.55 | WY |
| TOTAL | 156,868,277 | 101,280,287 | 646 | $85.50 | $144.26 | $202.81 | $58.55 | $209.32 | $65.06 | $222.33 | $78.07 | $339.43 | $195.17 | TOTAL |

(1) FHWA HIGHWAY STATISTICS 1985
(2) THOUSANDS OF GALLONS
(3) IN GALLONS

# STATEMENT
# OF
# THE AMERICAN BANKERS ASSOCIATION
# TRUST DIVISION

The American Bankers Association is pleased to have the opportunity to express the views of the bank trust departments on the estate and gift tax proposals contained in the revenue options paper. The American Bankers Association represents commercial banks whose combined assets comprise more than 95% of the industry total. Nearly 4,000 bank trust departments provide estate settlement and other fiduciary services to customers thus we are familiar with and vitally interested in the transfer tax system.

Our Association questions the apparent desire to seek significant added revenue from the estate and gift tax sector. A new generation-skipping tax which imposed a tax on direct transfers was adopted only last year. Under that same 1986 law estates open for more than two years are required to pay estimated income taxes. These changes have already increased the revenues derived from this area and added very significantly to the complexity of the law and costs of compliance.

The transfer tax system is the result of a carefully fashioned balance, effected over many years, of capital formation and distribution policy on one hand and revenue needs on the other. To impose significant change on that system in the context of seeking quick revenue increases may upset that balance. We urge the Congress to act slowly and deliberately in this complex area of the tax law.

At the same time we recognize the need for additional revenue and the fact that fairness dictates the burden be shared by all taxpayers.

The newly enacted Section 2057 which provides an estate tax deduction for sales to an ESOP is generally seen to have been drafted in an overly broad fashion. We concur in the proposals to clarify this provision as embodied in H.R. 1311 and S. 591.

On the other hand ABA finds it particularly troubling that the concept of a capital gains tax at death has been resurrected. Elimination of the step-up in basis was adopted in 1976. At that time imposition of a capital gains tax at death was considered and rejected in favor of a carryover basis. Carryover basis quickly proved to be disastrously unworkable and was repealed in 1980 without ever having taken effect. The fatal flaw involved in repealing the step-up in basis is the difficulty of proving original basis for the purpose of determining gain. It is a common human failing not to keep records. As a result an executor often cannot even determine when, much less for how much, an asset was acquired. The burdens of proving basis are excessive, and apply to taxable estates of all sizes. As was made abundantly clear during the legislative debate to repeal carryover in the late 1970's, modest-sized estates comprised largely of a small family business or farm are most adversely impacted. Nothing has occurred in the interim to make repeal of the step-up in basis any more feasible or desirable today and, therefore, it should be avoided.

If Congress finds it necessary to raise even more revenue from the transfer tax area, continuation of the 1987 rates would not be seen as detrimental to the structure of the tax. Further changes at this time are undesirable.

We appreciate the opportunity to provide our views at this time and would be pleased to provide additional information on request.

# Statement of the
# American Bankers Association
# Submitted to the
# Committee on Finance
# United States Senate
# On Revenue Increase Options
# August 17, 1987

The American Bankers Association (ABA) submits its views on the possible options to increase revenues under consideration by the Committee on Finance in connection with the Fiscal Year 1988 Budget Resolution. The ABA is the national trade and professional association for America's commercial banks of all sizes and types. Assets of ABA members banks comprise about 95 percent of the industry total.

In reviewing the revenue increase options contained in the Joint Committee on Taxation (JCT) staff options booklet, JCS-17-87, the ABA has two overall concerns that recur in our analysis of the specific proposals.

First, proposals which raise only minimal revenues and which change long-standing fundamental provisions of the Code are not appropriate for a budget reconciliation measure.

Second, in fairness to taxpayers, any new proposals should not apply to transactions consummated prior to the date of enactment of the Budget Reconciliation Act, or at the earliest, the day the Finance Committee reports out the bill. Proposals which have a retroactive effect unfairly penalize taxpayers by altering the taxation of existing investments and on-going transactions.

We believe these two general principles are important elements in maintaining sound tax policy as the Committee approaches the task of reporting out legislation which raises revenues as required in the FY 1988 Budget Resolution. If revenues must be raised, the objective should be to do so while avoiding to the maximum possible degree undue complexity, and retroactivity.

The ABA submits its views on five specific revenue options described in the JCT booklet of June 25, 1987.

## Amortization of Intangibles

The ABA strongly opposes the proposal to deny or severely limit the amortization of "customer-based" intangible assets purchased in a taxable merger or acquisition. In general, the tax law should not discriminate in this way between businesses which have mostly tangible assets and those industries like banking, which have a significant amount of intangible assets. Moreover it appears that the revenue increase proposal would retroactively cut-off hundreds of bank tax cases in various stages of IRS audit or pre-trial litigation concerning the amortization of costs associated with the acquisition of a bank "core deposit base." These bank mergers or acquisitions were negotiated, priced and consummated under existing tax law which permits an amortization deduction of the cost of intangible assets if, and only if, the taxpayer can prove that the asset has a determinable value and measurable useful life. We oppose this option not only because it is retroactive in its effect, but also because it constitutes a complex change in a long-standing and fundamental tax rule which generates an insignificant amount of revenue within the three year budget period.

The distinction in the existing tax law between amortizable intangible assets and those which are non-deductible like goodwill has been developed over a long period of time and is adaptable to a variety of unique situations. Banks often own intangible assets such as credit card customer lists, mortgage servicing rights, loan contracts, etc., the amortization of which has been accepted in court cases and IRS rulings. In Rev. Rul. 74-456 the IRS underscored the usefulness of the basic rule on amortization of intangibles in the context of so-called customer-based assets. The ruling points out that such assets are generally an indivisible part of the whole business, with no determinable life and, therefore not subject to amortization. The ruling goes on to state, however, that if the taxpayer can demonstrate that the asset is susceptible to valuation and is of use in its trade or business for a measurable limited period of time, an amortization deduction is allowable. Thus, the deductibility of the costs associated with any intangible asset turns on factual issues best determined on a case by case basis, by the IRS or the courts, using the long-standing principles of the Code.

In the banking industry core deposits are intangible assets recognized by the federal bank regulators and the accounting profession. See OCC Banking Circular 164, July 1, 1985. The deposit relationship is an extremely valuable component in the profitability of any bank. Deposits provide a ready source of funds from which a bank can generate a future income stream and a deposit relationship becomes an avenue for selling the bank's income producing services. Competition for deposits by money brokers, non-banks and banks operating from outside the geographic market have forced banks to devote more resources to maintain their markets. Thus, core deposits are a diminishing asset with a limited useful life. Banks can determine the value and expected life of an established deposit base acquired by a new entrant into a banking market. A purchasing bank would normally pay a premium for the acquisition of these deposit relationships and upon showing value and useful life, should be entitled to an amortization deduction. In acquisitions of failing or failed banks where FDIC assistance is provided, the payment of a premium for the deposit liability is required. Since the purchaser would be recording the assets and liabilities at fair market value, it should have the opportunity to prove that it has acquired an amortizable asset separate and apart from goodwill. If legislation is adopted which precludes any amortization deduction, purchasers will be reluctant to pay the current level of FDIC premiums.

The IRS has raised the core deposit issue in many bank audit situations around the country. A few have already been litigated, but three key cases, with clear facts, are going to trial this Fall. Any legislative action now would pre-judge the application of long-standing tax rules to these already existing bank core deposit cases. If the proposal were made applicable to future amortization of these existing bank assets, it would, in effect, retroactively increase the cost of those assets to the acquiring bank. In light of the significant number of bank merger and aquisitions which have resulted from the breakdown of state law barriers and the decreased profitability of banking, Congress should not take action which would increase the cost of these acquisitions ex post facto.

## Customer Interest Expense Deduction on Home Equity Loans

The ABA is seriously concerned about the proposed changes to the deductibility of qualified residence interest expense. The experience with the new tax law, as applied to a developing market of home equity loan products, is not sufficient to undo decisions made just last year. Information on which the decision should be made regarding who is taking out home equity loans and for what purpose is not yet available, although speculation about abuses is running high.

Specifically, ABA is concerned that limiting interest deductions to acquisition indebtedness will erode the ability of middle income homeowners to borrow against their one valuable asset for appropriate uses such as educational or medical expenses. Limiting interest expense with a specific cap (such as $10,000) will create problems in a rising rate environment, with variable interest rate loans a taxpayer's interest expense could rise above the cap even while the taxpayer was paying down the debt. And denying deductibility of interest on home equity loans without a fixed term would merely force consumers to forego the convenience of today's credit lines for yesterday's loan, without providing additional revenue for the Treasury.

Home equity loans are not new loan products, but rather a derivation of the traditional second mortgage, redesigned to reflect changes in the credit market and to better meet the needs of customers. The second mortgage exists now as a home equity installment loan, or as a home equity line of credit. The revolving credit line permits a consumer to borrow and repay as need requires, usually for a specified period which may range from five to ten years. During this period the borrower pays interest only, or a portion of the principal plus interest. The interest rate is often a variable rate which is indexed to a short-term market rate, although consumer reluctance regarding variable rates has led some banks to offer fixed rate credit lines. After the revolving credit period, the balance may convert to a fully amortizing loan, or may be required to be paid in full, a balloon payment.

Home equity loans are popular not only because of the tax deductibility but also because the revolving line feature and the higher credit limit available on home equity loans give consumers the ability to access a non-liquid asset and accommodate most of their lending needs on their own, without repeated visits to the bank. The customer can access the money (with a check, a coded telephone call or credit card) and make repayments without interacting with the banker again. Interest is paid only when there is a loan balance, and only on the amount of credit needed at any given time. Home equity loans may also offer borrowers more competitive rates than other consumer loans, and a longer repayment term.

In order to make sure that consumers fully understand both the opportunities and complexities of home equity loans, the ABA has undertaken a broad public awareness campaign urging that banks exercise good judgement in their advertising, and provide consumers with the information necessary to make a wise borrowing decision. The ABA has also urged consumers to avoid debt overload, temptation toward frivolous spending and borrowing solely motivated by tax advantages.

ABA further urges Congress not to require financial institutions to report additional information on qualified residence interest. Lenders are already required by DEFRA 1984 to report to the IRS and to the payors, interest paid on debt secured by real estate. Banks do not have the information necessary to further insert themselves into the process of determining whether or not that interest is tax deductible. The structure of a typical home equity loan does not lend itself to any requirement that the bank track the use of the proceeds. In determining whether or not a line of credit is to be approved, the bank is concerned about the fair market value of the property securing the loan, the amount of other debt for which the property is security, and the gross income and cash flow of the borrower. In fact, the bank has no control over the actual expenditure of the funds. It is not even possible for a bank to track the use of the loan based on the checks drawn, as it would not insure that the payments were made for qualified tax expenses.

The information necessary to compute deductible mortgage interest expense can only be provided by the individual using the loan proceeds. The bank does not need this information to make its credit decision and cannot reasonably be expected to accept either the responsibility or the underlying liability for determining the deductible portion of a customer's interest expense payments.

## Securities Transfer Excise Tax

The securities transfer excise tax (STET) is a new revenue option growing out of the stock transfer tax proposed by the Speaker of the House earlier this year. While the proposal has not been presented in legislative form, it appears that the STET would have major economic significance, apart from its revenue potential. The STET proposal should be subject to considerable analysis and debate in a public forum instead of being incorporated into budget reconciliation legislation which is designed for expedited action in the Congress.

The ABA comments on this proposal are designed to raise, on a preliminary basis, the concerns which we believe ought to be examined in depth if the Committee on Finance decides to pursue the option.

Although the details of the proposal are not available, certain elements of the macro economic impact of a STET are clear at least in direction. A STET is a tax on the saving/investment process. To the extent that the tax reduces savings, the growth and productivity of the U.S. economy will suffer. A lower savings rate also has implications for the international competitiveness of U.S. producers. If capital formation is retarded, U.S. firms will be less productive than foreign firms, making U.S. goods less attractive in both domestic and foreign markets.

By most measures, the current U.S. savings rate is low relative to the overall post war period. And while cross-country comparisons are difficult, there is general agreement that the U.S. savings rate is significantly lower than the savings rates of other industrialized countries. For example, a recent study published by the Federal Reserve Bank of Kansas City indicated that in 1985, the U.S.

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personal savings rate was 5.1 percent compared to 22.5 percent in Japan, 11.9 percent in the U.K., and 13 percent in West Germany.

Beyond these broad economic considerations the ABA is concerned that the STET would have some very serious impacts on financial institutions, their products, their liquidity through the federal funds market and their asset and liability management. The STET, as briefly described, may apply to both equity and debt instruments, whether or not publicly traded. While the Documentary Stamp Tax which was repealed in 1965 exempted all certificates of deposit (see then existing regulations sections 43.4311-2(b) (5)), it appears that the STET could apply not only to negotiable CD's but also passbook savings accounts, credit card charges and other routine transactions between the bank and the consumer. Extending the tax to these consumer transactions of millions of accountholders would have a significant impact on the average citizen.

The impact of the STET on consumers would be even greater if it applied to both the original issuance and secondary market transfers of debt instruments. It would seem to be a curious message about government policy on savings to tell a customer that there is a tax when he opens a passbook account, obtains a CD, or makes additional deposits.

The application of the tax to the issuance and resale of government debt obligations also raises serious questions. Would the U.S. Government pay a tax on the issuance of T-bills and Treasury obligations and notes? These debt obligations are marketed by the commercial banks serving in the role as dealers, both in the U.S. and worldwide. Would the banks also have to pay the tax on the secondary transfer from the dealer bank to the investor? The same considerations apply in the case of state and local obligations marketed by banks, plus the added concern about the constitutionality of taxing transfers of such debt.

Another concern about the scope of the tax involves the possible application to overnight federal funds transactions by commercial banks. Federal funds are bank balances on the books of the Federal Reserve banks. Commercial banks that have excess reserves lend those reserves, usually overnight, to other banks with deficiencies in their reserve positions. This represents an alternative and more productive use of funds that banks may have idle for short periods. Applying the tax on these transfers would put a premium on precisely determining reserve balances, a goal that is difficult if not impossible to obtain. Banks could find themselves in the position of paying a tax for the liquidity that is available through the federal funds market.

The possible application of the STET to futures, forwards and options raises a number of concerns about its impact on bank asset/liability management. Commercial banks participate in futures markets subject to federal bank regulations. Futures instruments are crucial for banks which hedge positions to protect themselves against the risk of interest rate or currency exchange rate fluctuations. For example, an asset such as an investment portfolio would decline in value as interest rates rise. A bank can protect itself against this asset depreciation by taking a short position in the futures market so that as prices fall the loss in the cash market is offset by profits in the futures market. On the other hand assets such as loans are at risk when interest rates fall.

These same principles apply in trading account activities, debt issuance, trust management and mortgage banking. Application of a tax on these hedging actions designed to reduce bank risks will not only increase bank costs, but also make the futures market less efficient and likely reduce its correlation with the cash market. At a time of significant fluctuations in interest rates and currency exchange rates, any proposal to tax the actions necessary to reduce risk of loss would be contrary to maintaining a safe and sound banking system.

It should be evident that the STET is a complex proposal, something more than just an additional charge at the end of a customer's monthly bank statement. Full review of the impact to the STET on financial institutions should include consultation with the Treasury Department and the federal regulatory agencies responsible for supervising the nation's commercial banks.

## Withholding Tax on Interest Paid to Foreigners

The ABA urges the Committee to reject any proposal to impose a low rate of tax on interest paid to foreigners which is presently exempt from the 30% withholding tax. Sections 871 & 881 of the Code now specifically exempt interest on non-resident alien bank deposits, portfolio interest, and short-term original issue discount (on obligations with maturities of 183 days or less), while certain other interest payments are exempt by means of bilateral tax treaties. These provisions are designed to attract foreign capital investment to meet the credit needs in the U.S. As a result, both corporate borrowers and the U.S. Treasury have been able to raise substantial funds from foreign investors at lower interest rates. The imposition of even a low rate tax on these interest payments to foreign investors would create a disincentive to acquire obligations issued by U.S. borrowers and place unnecessary pressure on the U.S. debt markets. The possible benefit from increased revenue collected under such a tax would be outweighed by the substantial economic cost of higher interest rates and would be off-set in a revenue sense by increased interest deductions.

Congress has historically endorsed a policy to allow certain U.S. borrowers to compete for foreign capital on a tax-free basis. Most notably, since 1921 foreign persons have been exempt from U.S. tax on interest on deposits from U.S. banks, saving and loan institutions, and similar financial institutions. According to 1984 Treasury Department testimony, this exemption for bank deposit interest reflects the need to keep the international competitiveness of U.S. financial institutions. To impose a U.S. tax on interest paid to foreign persons by U.S. banks would reduce the ability of U.S. financial institutions to compete for foreign funds and would seriously erode the efficiency of international capital markets. In the 1986 TRA Congress revised the form of the exemption for interest on bank deposits, changing from a source rule provision to a statutory exemption, but no consideration was given to eliminating the exemption for interest on bank deposits.

The portfolio interest exemption adopted in 1984 is equally important. Under that provision all borrowers (Treasury, Government agencies and corporations of all sizes) can now issue debt obligations directly out of the U.S. for sale to foreign investors. These U.S. borrowers can benefit from a healthy competition between the U.S. domestic and Eurobond capital markets which results in overall lower interest rates, greater liquidity, and a broader market for their obligations. The Treasury Department testimony before this Committee in 1984 in strong support of the portfolio interest exemption was based on its view "that efficient capital markets are an important element in achieving both increased capital formation and sustained economic growth in the United States. Access to foreign capital in such markets requires that interest on borrowed funds be available free of source-country taxation."

At a time when there is a tremendous capital deficit in the U.S. and when the declining value of the dollar discourages some foreign investors from taking the dollar-denominated debt, no additional barriers to foreign capital should be considered. The recent flap over the notice of termination of the U.S.-Netherlands Antilles Tax Treaty, which may result in application of the 30% withholding tax on pre-DEFRA Eurobonds, should be clear evidence that the present exemption from the tax is crucial to encouraging foreign portfolio investment in the U.S.

## Taxation of Credit Unions

The President's 1985 Tax Reform proposal included a recommendation that credit unions having assets of $5 million or more should be taxed like other thrift institutions. This proposal is included in the JCT booklet on revenue options, with a revenue estimate of $1 billion over three years. The tax-exemption for credit unions was adopted in 1951, when credit unions were small institutions with limited powers serving limited markets which did not compete with other types of financial institutions. Over the years, credit unions have grown enormously in size and diversity. This growth has blurred the historical differences in activities between the tax exempt credit unions and taxable financial institutions so that the tax exemption is no longer warranted. The changes that have eroded the uniqueness of credit unions have occurred in three key areas: erosion of the financial stake, deterioration of the common bond, and the growth of new products and services.

Introduction of Federal share insurance in 1971 significantly altered the nature of credit unions, so that members no longer have the same financial stake in the success of the organization. In the early history of credit unions, emphasis was placed on the fact that depositors stood to lose some of their own funds if some borrowers did not repay their loans. Risks of loss of one's own funds provided strong incentive for repayment of loans and close supervision of the lending function, creating an important link between the lending side and the deposit side. Share insurance has severed the link, because credit union members can now look to federal insurance to protect them against risk of loss.

Changes in the common bond requirement for credit union membership by the National Credit Union Administration (NCUA) and state regulators allow credit unions to compete with banks and savings and loans for customers among the general public. The NCUA stated that deregulation of the field of membership policy began in April 1982, but the common bond requirement had been loosely interpreted for many years before that date. For example, in 1968, authorities ruled that a person could continue to be a credit union member even after the common bond was severed.

Other changes which have eroded the traditional common bond characteristic include deregulation of the immediate family definition, elimination of the requirement for similar common bonds in multiple groups charters, and expansion of the geographic area that may be served by a multiple group charter. According to NCUA, "the essential basis for all the changes in the field of membership policy since April 1982 is to provide credit union service to people who do not presently have credit union service available to them." This is, in effect, an admission that there really is no field of membership limitation.

Credit unions have also evolved beyond their traditional mutual benefit savings and loan product offerings into full service financial organizations. An August 30, 1985 Wall Street Journal article concluded that: ".... while consumer lending is still their bread-and-butter business, some of the larger credit unions have recently been offering such gourmet fare as credit cards, individual retirement accounts, discount-brokerage services, automated teller machine networks and computer-authorized loans."

A provision of the 1987 Competitive Equality Banking Bill, recently enacted into law will make credit unions competitive in the quest to attract public unit deposits. Prior restrictions on credit union pledges made government bodies reluctant to deposit more than $100,000 but credit unions sought and obtained legislation that permits them to pledge assets other than loans to secure public deposits.

The competition is substantial, especially for community banks. Because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loans. The changes in the operation and customer base of credit unions caused the Administration to recommend repeal of the tax exemption for large credit unions as part of "The President's Proposal for Fairness, Growth and Simplicity." The proposal noted that, "in an economy based on free market principles, the tax system should not provide a competitive advantage for particular commercial enterprises. Credit unions should generally be subject to tax on the same basis as other financial institutions."

The American Bankers Association recommends that the Committee consider and repeal the tax exemption provided for credit unions.

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Our Association appreciates the opportunity to submit a statement on the revenue increase options. Additional information can be obtained from Henry Ruempler, Tax Counsel, American Bankers Association, 1120 Connecticut Ave., N.W., Washington, D.C. 20036, (202) 663-5317.

# STATEMENT OF
# THE AMERICAN COUNCIL OF LIFE INSURANCE
# AND
# THE HEALTH INSURANCE ASSOCIATION OF AMERICA
# ON OPTIONS TO RAISE REVENUES
# AUGUST 17, 1987

## INTRODUCTION

This statement is submitted on behalf of the American Council of Life Insurance and the Health Insurance Association of America to express our opposition to proposed revenue options which relate to the tax treatment of insurance and employee benefits. We believe the current tax rules in these areas reflect a balancing of important social policy, tax policy and revenue considerations. Moreover, the rules in these areas have been intensively and continuously examined over the past six years and extensively revised by the last three tax Acts. The resulting rules and the delicate balance they reflect should not be dismantled solely out of a concern for revenue.

Individuals should be encouraged to provide for their long-term financial security. Insurance and employee benefit plans are two of the principal means to achieve this. Life insurance provides a means for taxpayers to protect against untimely death; annuity contracts are important means to save for retirement needs; and health insurance protects against financial disaster caused by illness or disability. Employee health and life insurance programs allow the provision of such protection through the work-place. Tax disincentives to providing these valuable protections should not be enacted, particularly at a time when the need for private sector programs is increasing because of cutbacks in social programs and increases in health costs.

The Congress has consistently recognized the importance of encouraging provision for long-term financial security, both through individual insurance and through employee benefit plans. Moreover, comprehensive tax rules have been carefully designed to ensure that life insurance and annuity products qualify for the current tax rules only if they provide such long-term security and that employee benefits, such as group health and group life, so qualify only if they are available for low- and middle-income taxpayers. This policy and its implementation have been constantly reviewed and updated. For example:

1. The Tax Equity and Fiscal Responsibility Act of 1982 extensively revised the tax treatment of annuities and certain life insurance contracts, and began the process of revising the life insurance company tax rules.

2. The Deficit Reduction Act of 1984 included a thorough revision of the tax treatment of life insurance companies and their products. These changes followed over two years of careful study. Moreover, the 1984 Act provides for studies of the operation of the 1984 Act on the taxation of insurance companies and their products. Thus, the tax treatment of insurance will continue to be studied, as reflected in the Subcommittee on Select Revenue Measures recent announcement of hearings.

3. During the debate leading to the Tax Reform Act of 1986, basic tax fundamentals for life and health insurance were again reviewed, including the tax treatment of inside build-up, employee benefits, and life insurance company reserves. Significant changes were made in the nondiscrimination rules for employee benefit plans, in the tax treatment of certain insurance products, and in repealing the special life insurance company deduction.

In view of these very recent Congressional reviews and the scheduled re-examination of the insurance tax rules, it does not make sense to re-examine these provisions in the hurried context of budget reconciliation. To a very large degree, the revenue options in these areas were thoroughly examined and debated and acted on in one way or another during consideration of these recent Acts.

For these reasons, we urge that the life and health insurance and employee benefit issues raised in the options be removed from the Committee's agenda. They generally involve small amounts of revenue, but entail complicated, broad and already considered implications for our business and the American public.

There follows a more detailed discussion of some of the possible revenue options relating to the life and health insurance business.

## DISCUSSION OF SPECIFIC REVENUE OPTIONS

### TAXATION OF INSURANCE PRODUCTS -- (Item II(D)(13)(a))

### 1. Life Insurance

Several revenue options involve significantly revising the tax treatment of life insurance policies. Three different approaches are suggested: taxing the inside build-up of values in a life insurance policy, redefining what constitutes a life insurance policy for tax purposes, and changing the current framework for taxing distributions and loans from life insurance policies. We strongly believe that current law represents sound tax policy in all these respects and should not be changed.

We understand that some of these proposals may have been suggested in response to recent advertising and marketing of single premium life insurance policies. In this regard, marketing emphasis should not be permitted to blur reality. In fact, single premium life insurance policies conform to the definition of life insurance which was carefully designed in 1984. As such, they do not provide for the accumulation of funds beyond the amount which was deemed appropriate to provide life insurance protection for the whole of life. Moreover, the taxation of distributions and loans under single premium life insurance policies is no different than the tax treatment applicable to all other types of policies, which we believe to be reasonable and to conform to widely applicable tax principles.

#### A. Current Taxation of Inside Build-up

-- The policy of the United States tax law has been to encourage American families to protect themselves through the private insurance system. This policy was reaffirmed in the Tax Reform Act of 1986 despite Administration efforts to currently tax the inside build-up. The necessary effect of increasing the tax burden associated with life insurance would be to increase its cost and discourage its utilization by those least able to assure their financial security by other means. This would leave a gap in family protection which inevitably must be filled by public programs.

-- Taxing a policyholder currently on the increase in the value of his life insurance policy would be inconsistent with the historical and fundamental concept of tax law that persons are not taxed on unrealized amounts which they cannot receive without giving up important rights and benefits.

-- The reduction in the sale of permanent life insurance stemming from an inside build-up tax would impair private capital formation and economic growth. Life insurance company funds are invested until they are paid in the form of benefits. Life insurance companies have long been a major source of long-term investment capital.

#### B. Revision of Definition of Life Insurance

-- To qualify for tax treatment as life insurance, a contract must meet the definition set out in Internal Revenue Code Section 7702. This definition was carefully designed in 1984 as part of an overall reform of the tax treatment of life insurance companies, their products, and their policyholders, and was again reviewed during the 1986 Tax Reform debate. Few sections of the Internal Revenue Code have received as much scrutiny as Section 7702. It draws the line that defines life insurance contracts at a proper place, in distinguishing between contracts that serve primarily as vehicles for life insurance protection as opposed to investment return.

-- In recognition of the fact that insurance costs increase with age -- and may become prohibitive at older ages -- premium payment plans under whole life policies can range across the entire spectrum from level payments for life to a single payment at the beginning -- or there may be no prescribed schedule. Section 7702 accommodates all of these variations, and this is entirely proper because it encourages the important social policy of purchasing whole life insurance. Section 7702 achieves this by focusing, not on particular product design features, but on the relationship between the funds accumulated and the benefits provided. Stated simply, the Section 7702 tests limit the funds that may be accumulated under a life insurance contract to those amounts deemed appropriate to provide the future benefits promised under the contract.

-- Section 7702 has had a substantial impact. Following its enactment, several long-standing product designs were totally eliminated -- e.g., endowment and retirement income contracts where any insurance element may disappear during the insured's lifetime. Other products had to be redesigned to put in a greater death benefit (e.g., increasing face amount insurance).

-- The funds in a life insurance contract cannot produce investment results for the policyholder comparable to those which can be realized under an investment vehicle. This is because there is a mortality cost associated with the payment of the death benefit and a cost to the insurance company of administering its insurance business; these costs must be met from the insured's premium dollars or from the company's investment return.

In this regard, one of the revenue options assumes that earning a high yield is inconsistent with life insurance treatment. This is an incorrect perception. The use of a current investment return under life insurance policies is intended to provide lifetime protection at the lowest available cost. Moreover, as already discussed, high investment return cannot be used to build policy accumulations above that permitted by the Section 7702 formulas.

## C. Revision of Tax Treatment of Distributions and Loans Under Life Insurance Policies

Distributions. If a policyholder fully surrenders his life insurance policy, any gain in the policy is taxed at that time. Amounts received pursuant to a partial withdrawal or surrender are taxed under a hybrid system. During the first 15 years of the policy, they are taxed under the rules of Section 7702(f)(7)(B). Thereafter, they are considered to constitute first, a withdrawal of the policyowner's investment in the contract and then, a withdrawal of any gain under the policy.

These tax ordering rules are consistent with sound tax policy principles; a universal income first rule should not be adopted.

-- As part of its tax reform efforts in 1986, Congress reviewed the current rules and prescribed a very detailed mechanism for determining when and to what extent taxable income should be recognized before basis is recovered. This mechanism (Section 7702(f)(7)(B)) taxes distributions in the first 15 years of a policy when there is gain in the policy and cash values are at or near the maximums permitted by the definition of life insurance. Thus, it addresses in the distribution context, the problem area that has concerned Congress; that is, the use of life insurance as investment, rather than protection vehicles. Clearly, this problem-specific approach is far preferable to an indiscriminate approach that would adversely affect all types of policies held by individuals at all income levels.

- Altering the income recognition rules as proposed would be extremely harsh on policyholders. For example, if a policyholder needs to withdraw some funds from his life insurance policy to meet emergency expenses or to pay heavy expenses, such as college tuitions, such a reordering rule could increase his financial burdens by triggering a tax on gain in the policy up to the amount of his withdrawal.

Loans. In addition to withdrawals and surrenders, the owner of a permanent life insurance policy is able to use the values in his policy as collateral for a loan. Such a loan can be made directly from the life insurance company or from a third party. In either case, the loan requires interest payments and must be repaid. The Congress and the IRS have historically recognized that typical life insurance policy loans are loans for tax purposes. Thus, as with loans generally, loans secured by life insurance policy values do not currently result in a taxable event. This result should not be changed.

- A loan secured by the value of a life insurance policy is like any other loan secured by property. Interest accrues on the loan and must be paid. Moreover, the creation of the debt does not extinguish the policyholder's ownership rights in his policy.

  The situation is very analogous to that of a homeowner who takes out a home loan. The homeowner retains the rights and duties of ownership. Similarly, a life insurance policyholder who takes out a policy loan does not surrender any part of his life insurance coverage but remains protected by the policy. If he repays his loan, he is entitled to payment of the full amount of the death benefit without any requirement to re-establish his insurability or to pay higher premiums based on his then attained age. In either case, the only possible rationale for creating a taxable event in the case of a loan is to equate the loan with a sale or distribution of the value of part or all of the underlying collateral. This is simply not what occurs.

- In the past, proposals have often been made with regard to life insurance policy loans in response to a perceived tax advantage flowing from the fact that the policy loan interest was deductible while the policy's inside build-up was not taxable unless it is withdrawn. This situation was essentially eliminated for all consumer loans and most business policy loans by the 1986 Tax Reform Act. Thus, this issue can no longer justify adverse tax treatment for policy loans.

- The fact that loans under non-qualified deferred annuity policies are treated as distributions for tax purposes does not justify similar treatment for life insurance policy loans. Congress has specifically defined in Section 7702 the characteristics which distinguish a life insurance policy from an investment motivated vehicle. There is no comparable definition for annuities; instead, Congress has taken an entirely different approach for annuities by crafting special taxing rules to draw the lines it desires.

## 2. Annuities

Two revenue options would substantially alter the tax treatment of non-qualified deferred annuity contracts. Under one option, an annuity policyholder would be taxed currently on the annual increase in cash value credited to his or her annuity contract (the "inside build-up"). The second option would limit the amount that a policyholder could invest in a newly issued annuity on a tax-deferred basis. These issues have been thoroughly reviewed in the past, and for the reasons discussed below, Congress should, once again, reject the proposals.

### A. Taxation of Inside Build-Up

- In 1982, 1984, and 1986, Congress made substantial changes to the treatment of deferred annuities in order to ensure that annuity contracts are used for retirement purposes and not as short-term investments. As a result of these changes, if a policyholder makes a premature withdrawal from an annuity, the amount withdrawn is considered to come first from currently taxable income. Furthermore, a penalty tax of ten percent generally is imposed on withdrawals that occur before the annuity owner has reached age 59 1/2. Thus, an inside build-up tax is not warranted on the grounds that annuities are, in reality, investments.

-- The deferred annuity contract is not a tax-avoidance device that needs "reform". Premiums paid for annuities are not deductible from gross income. Moreover, present-law rules do not forgive taxes on the investment earnings, they only provide for a deferral of tax. All income credited to the contract is taxed at ordinary rates when distributed to the contract owner.

-- As in the case of life insurance contracts, taxing the inside build-up on annuity contracts would mean that policyholders would be taxed on amounts they have not received and cannot receive without giving up basic benefits.

B. Limit the Amount that a Policyholder May Invest on a Tax-Deferred Basis

-- Limiting the amount of premiums that an individual may pay for an annuity contract and not be taxed currently on the income credited to the contract fails to recognize the different retirement needs for individuals. Such a proposal does not take into consideration individuals who live in high cost areas or who may have obligations that extend beyond their working years. Arbitrarily imposing a limit would force these individuals to either restrict their contributions, and thus face the possibility of not providing adequately for their retirement years, or pay tax on income they have not received.

-- The statement contained in the options pamphlet suggesting that non-qualified annuities "circumvent important rules applicable to qualified plans" does not take into consideration the changes enacted by Congress just last year. The Tax Reform Act of 1986 provided that the inside build-up on corporate owned annuities would be subject to taxation, thus, ensuring that deferred annuity contracts could not be used, on a tax-deferred basis, to fund deferred compensation of employees outside the restrictions generally applicable to qualified plans.

Most importantly, neither proposal recognizes the unique characteristic of a deferred annuity contract that makes it one of the most suitable means of providing for an individual's retirement security. Unlike other vehicles, deferred annuities provide protection against the possibility of outliving one's financial resources. For sound social and tax policy reasons, Congress should continue to encourage a policy which assures financial security and independence after retirement.

## EMPLOYEE BENEFITS

### 1. Group Health Insurance -- (Item II(D)(5)(a)(1) and (5))

Among the revenue options are proposals to limit the exclusion of employer-provided health coverage by (1) including in an employee's income employer contributions to a health plan to the extent that they exceed a specified cap; (2) including in an employee's income employer contributions to a health plan up to a specified floor; (3) including all or a portion of employer contributions to a health plan in an employee's wages but only for FICA and FUTA tax purposes; and (4) including all employer contributions to a health plan in the income of employees earning at least $60,000 annually.

We are unalterably opposed to any form of taxation of employer contributions to health benefit plans for the following reasons:

-- At the very time when ways are being explored to expand the availability of health coverage for those currently uninsured, it would be counter productive to impose new taxes which would discourage the provision of health coverage. The issue of taxing group health insurance was extensively considered and rejected less than a year ago during the tax reform effort.

-- The burden of a tax cap would fall unequally on workers depending upon where they work, their ages, and their occupations. Taxing group health insurance this way would discriminate against workers in high health care cost areas -- California and New York for example. A tax cap would also have a heavy impact on groups composed primarily of older workers or workers employed in high-risk or hazardous occupations, since higher health premiums must be paid for such groups. A cap would also place essential preventive health care in jeopardy since employers would be discouraged by the cap from making contributions for other than catastrophic coverage.

-- The burden of a tax floor would hit millions of lower- and middle-income families. It would introduce a disincentive for employees to continue their health insurance coverage.

-- Limiting the proposal to only the FICA and FUTA taxes would not avoid the basic problems outlined above. Also, this approach would place the full burden of the tax on those low and moderate income families who are in greatest need of the coverage.

2. Group-Term Life -- (Item II(D)(5)(a)(2) and (5))

Among revenue options under consideration are suggestions for repealing the exclusion for the first $50,000 of employer-provided group-term life insurance for income and/or payroll tax purposes. One proposal would repeal the exclusion only for individuals with incomes in excess of $60,000 per year. We oppose repeal of the $50,000 exclusion for either income or payroll tax purposes for the following reasons:

-- The tax exclusion for employer-provided group-term life insurance has been invaluable in encouraging employers to sponsor plans and employees to participate in those plans. At the end of 1985, 96% of all full-time workers employed by medium- and large-sized firms were covered by group-term life insurance. This coverage amounted to 42.3% of the life insurance in force in the United States.

-- In eliminating the $50,000 exclusion for group-term life insurance, Congress would be removing a benefit of importance to lower- and middle-income employees. It would be requiring the great majority of American workers to pay a new tax in order to keep their group life insurance protection in force. This could have a very detrimental effect on keeping this valuable financial protection in place.

-- Group-term life insurance may represent the only financial protection available for a survivor in the event of the untimely death of an employee. For example, in many cases, workers cannot medically qualify for individual life insurance or cannot qualify because of their occupation. The proportion of workers who are uninsurable for individual life insurance has been estimated to be as much as 10 percent. It is only through group underwriting that private insurance can provide protection for these persons.

-- Limiting the proposal to only the FICA and FUTA taxes would not avoid the basic problems outlined above. Also, this approach would place the full burden of the tax on those low and moderate income families who are in greatest need of the coverage.

3. Cafeteria Plans -- (Item II(D)(5)(a)(6))

The proposed revenue options would cut back the income tax exclusion for cafeteria plan benefits in several possible ways, i.e., by: (1) limiting the cafeteria plan exception to the constructive receipt principle to $500, for income, FICA and FUTA tax purposes; (2) completely repealing the cafeteria plan exception to the constructive receipt rules for FICA and FUTA purposes; or (3) effectively preventing dependent care assistance accounts from being offered in cafeteria plans. We oppose these proposed limitations on cafeteria plan benefits for the following reasons:

-- The $500 limit, if adopted, would dramatically reduce the appeal and thus, ultimately, the availability of cafeteria plans. This would be unfortunate. Cafeteria plans are desirable from a social and policy standpoint because they enable employees to tailor benefits in a fashion that best suits their personal needs. Thus, duplicative or unneeded coverage is eliminated, and employees are encouraged to become more prudent benefit buyers. The availability of meaningful choice is especially important given the changing makeup of the American work force, which is composed increasingly of single parents, single employees and two-income families.

-- Cafeteria plans are subject to the requirements of Section 125 and, as of January 1, 1989, the nondiscrimination requirements of new Section 89. Together, these rules ensure that coverage is uniformly available and that there is not a disproportionate opting out by the low paid. Thus, if there is a concern that low-paid workers take cash instead of benefits under cafeteria plans, this concern is more than adequately addressed under current law. Further restrictions are unnecessary.

-- Limiting the proposal to only the FICA and FUTA taxes would not avoid the basic problems outlined above. Also, this approach would place the full burden of the tax on those low- and moderate-income families who are in greatest need of the coverage.

## LIFE INSURANCE COMPANY TAXES

### 1. Life Insurance Reserves -- (Item II(D)(13)(a))

Four different approaches are suggested for limiting the deduction presently allowed a life insurance company for additions to life insurance reserves. They include disallowing any reserve deduction, gearing the deduction to increases in cash value, requiring the use of a Federally mandated interest rate, and disallowing any reserve deduction in the alternative minimum tax.

None of these changes in the current reserve rules are warranted:

-- Some of these proposals obviously are based on the premise that the current levels of life insurance tax reserves are overly conservative (too high). This is wrong. In 1984, Congress carefully reviewed and substantially revised the tax rules governing reserves of life insurance companies. The new rules are far more stringent than the prior ones and assure that tax reserves will be lean.

Under the new law, to be recognized for tax purposes, reserves must not exceed the minimum levels required by the laws of a majority of the States. Moreover, the mandated reserve method produces reserves in early years substantially lower than the net level method which had been permitted under prior law. The new rules adopt the interest rates as well as the mortality standards prescribed by state regulators, which reflect the long-term nature of funds invested under life insurance contracts. One of the revenue options suggests that a Federally prescribed interest rate should be used, rather than the rate prevailing in the States. The rationale given is that such a federal rate is currently prescribed for discounting property and casualty insurance reserves. While in the 1986 Act it was necessary to prescribe a special Federal interest rate for these reserves because regulatory reserves are not discounted, this is not necessary for life insurance reserves. An appropriate rate already exists under State law and is adopted in existing tax law.

-- The result of not allowing any life insurance reserve deduction, or providing a deduction that is too low, would be irrationally harsh. It would place a life insurance company wholly or partially on the equivalent of a cash basis of accounting and, thus, would grossly mismatch income and expenses in the case of long-term liabilities assumed by life insurance companies. The result would be a current tax on gross premiums, rather than on net income like all other taxpayers.

-- The reserves and the cash values for a policy are not equivalents and they should not be interchanged for tax purposes. The reserve for a policy is the monetary measure of all of the life insurance company's obligations under the policy. The cash value is one of the benefits under the policy; i.e., it is the amount that will be paid to the policyholder as an equitable settlement if he or she surrenders the policy before the insured event. Some policies contain no cash value and the company need reserve only for the insurance obligation. On the other hand, even for policies with cash values, there are always benefits which are not reflected in the cash value but which must be reflected in reserves.

2. Capitalize Agents' Commissions -- (Item (D)(13)(g))

This revenue option would require the capitalization of insurance selling agents' commissions.

-- Agents' commissions are expenses that fall within the main stream ordinary income activity of a life or health insurance company. They clearly represent every day recurrent expenses directly related to the marketing and servicing of the products of that business -- insurance and annuity contracts. For many sound reasons, such expenses have historically been treated for tax purposes as period costs, i.e., costs which are currently deductible, even though they relate to the acquisition of a property interest. Similarly, for example, current deductibility is allowed for marketing expenses incurred by banks and securities firms although the relationship with the customer may extend over a number of years.

-- Moreover, the deductibility of agents' commissions, along with other first-year acquisition expenses, has already been accounted for in the reserving process for tax purposes. Under the reserving method required by the tax code (CRVM), practically no reserve is established for the first year of a contract. This reflects the fact that the first year's premium is essentially used to satisfy the first year's expenses, including agents' commissions. To also require capitalization of commissions would create rather than correct a mismatch when combined with the reserve method required by the current law. At the very minimum, any requirement of capitalization must be accompanied by a change to allow reserving under the net level premium method.

-- The proposed capitalization of agents' commissions is not necessary to accomplish consistency with the treatment of property and casualty insurance companies. The reduced reserve deduction required of those companies by the Tax Reform Act of 1986 relates to unearned gross premium reserves which contain an element of expense loading. In the case of life insurance reserves under the CRVM method, the only reserve allowed in the first year is based on the net premium or pure cost of insurance. No gross premium income deferral occurs.

-- The current law requirement that a life insurance company's acquisition expenses must be amortized in computing one of the preference items under the alternative minimum tax, without an offsetting change in the reserve method, is equally wrong. This mistake should not be compounded in the regular tax computation.

OTHER INSURANCE RELATED PROVISIONS

1. Reduction in Tax Preferences or Additions to the Alternative Minimum Tax Base -- (Item II(D)(2) and (15))

Several revenue options involve specifying "preferences" that would receive less than full tax effect. Under one approach, they would be added to the minimum tax base. Under another, their tax effect for regular tax purposes would be reduced by a specified percentage.

- -- These approaches, whether by way of the regular tax or the alternative minimum tax, cut across the existing income tax system avoiding and upsetting policy decisions established after exhaustive considerations. These policy decisions should be directly addressed; the need for revenues should not be used as an excuse for not doing so. Such "minimum tax" type of approaches represent arbitrary and uneven ways to raise revenue.
- -- Increasing the preference percentage of the seriously flawed AMT book income adjustment item as proposed would, as only one example, clearly compound the damage to any equitable or rational tax system.

## 2. Taxation of Life Insurance for Estate Tax Purposes -- (Item II(E)(3))

This revenue option provides for including, in the gross estate of a deceased individual, the proceeds of any life insurance policy payable directly or indirectly to a relative of such individual, even though the decedent does not own the policy.

(1) A major impact of this revenue option would fall on arrangements which have long been used to enable families to pass on a family business or farm from generation to generation despite having to pay substantial estate tax liabilities.

- -- What exactly would happen? For an owner of a small to mid-size business or farm, the business often constitutes most, if not all, of his estate. When the owner dies, an estate tax may be due, or debts may be owing on the business. If cash funds are not available, the estate may then be forced to sell the business or farm to raise the funds to pay the tax or other amounts. Since a business or farm is a highly illiquid asset, the sale may be under distress circumstances if market conditions are not right. Moreover, no matter what the market conditions, the result will be that the family will have lost the business or farm.
- -- The problem of forced sales of family businesses and farms is alleviated in many situations by the purchase of life insurance to provide the cash funds necessary to pay the estate tax or other amounts. The proceeds are available to lend to the estate or to buy the business from the estate at a fair market price. Because of its guaranteed death benefit, life insurance is the only vehicle which can insure that adequate funds will be on hand at the time of death.
- -- The proposed revenue option would impose an estate tax on the life insurance proceeds in this situation, even though the insurance does not increase the size of the estate. The new tax would make the cost of raising liquid funds nearly prohibitive and force many estates back into the situation of having to sell the family business or farm. For example, in the case of a family business valued at about $3.5 million, if the new tax is enacted, twice the amount of life insurance ($2 million, instead of $1 million) would have to be purchased to provide enough liquid funds to pay the estate tax.
- -- The revenue option could also severely impact common buy-sell arrangements where family members jointly own a business and life insurance is purchased to provide funds to surviving owners with which to buy the interest of the deceased owner.
- -- It is also possible that the revenue option could impose new estate taxes on proceeds under key-man life insurance arrangements set up by family-owned businesses to provide a transition on the death of one of the family owners.

(2) The revenue option is inconsistent with the concept of the estate tax by imposing a tax on property which the decedent does not own, and may never have owned, and thus cannot in any sense be considered to have transferred at his death.

(3) Finally, the revenue option would discriminate against life insurance since it would become the only type of property on which an estate tax would be imposed, even though the decedent transferred it to another person more than three years before his death.

3. Current Accrual of Market Discount Bonds -- (Item II(D)(6)(g))

This revenue option would require that market discount on bonds be accrued currently for tax purposes rather than at the time the bond is sold or redeemed.

-- The tax treatment of market discount bonds was extensively examined during the considerations leading to the Tax Reform Act of 1984. A comprehensive revision was enacted. At that time, the current accrual of market discount in income was considered and rejected. There is no good reason for reversing this decision. Achieving symmetry with the treatment of original issue discount on this relatively minor timing issue would require adding substantial complexity and cost to already overburdened business taxpayers and the IRS.

4. Withholding Tax on Interest Paid to Foreigners -- (Item II(D)(12)(c))

This proposal would impose a 5% withholding tax on United States source interest income due a foreigner not otherwise subject to the income tax of this country.

-- The taxation of such "portfolio interest" was extensively examined during the consideration of the Tax Reform Act of 1984. For good and sound policy reasons, the existing 30% withholding tax was repealed.

-- Most other countries do not impose similar withholding taxes. This fact has encouraged the free flow of investment dollars on an international basis and helped to stabilize marketplaces such as the Eurobond market. United States borrowers need free and equal access to such markets to raise required capital. The reimposition of a United States withholding tax would upset present balances and would generate very substantial pressure to provide new escape avenues by way of new treaties or other exceptions. Foreign investment dollars would tend to go elsewhere escalating the balance of payment problem, and the tax would tend to be self-defeating.

-- International financial markets need assurance of continued stability. The current serious problem involving Eurobonds acquired through international finance subsidiaries formed in the Netherland Antilles attests to the sensitivity and interdependent nature of such markets. Any revenue raised by this clearly inadvisable proposal could be expected to be at substantial economic cost.

5. Qualified Plan Loans Treated as Distributions -- (Item II)(D)(5)(b)(1))

This revenue option proposal would treat loans from a qualified plan as a distribution of plan benefits. Thus, all or part of any loan amount would be includible in income and, to the extent the loan represents a premature distribution of plan benefits, it would be subject to a 10% penalty tax.

-- The rules regarding loans from qualified plans were significantly tightened under TEFRA and further narrowed only a few months ago in the Tax Reform Act of 1986. The effect of these rules is to subject plan loans to stringent restrictions both as to amount and time of repayment. Thus, current law substantially restricts the ability to use loans to divert funds from retirement purposes. A complete prohibition is unnecessary.

-- The practical result of the revenue option will be to discourage many lower paid employees from contributing to pension plans. Lower income employees, who have limited discretionary funds, will be reluctant to commit funds to a qualified retirement plan if access to those funds is available only at the price of extremely adverse tax consequences.

-- While we agree that funds designated for retirement purposes should -- whenever possible -- be maintained intact, this is not always feasible when an employee faces an unanticipated financial need. While higher income employees are likely to have alternative borrowing options to meet such needs, for many of the lower paid a retirement plan is their only significant source of available funds.

## TAX PARITY PROPOSALS -- (ITEM II(D)(13)(c))

In looking for new sources of revenue, the commercial life and health insurance industry would encourage the Committee to consider the revenue options that would eliminate preferential tax subsidies to businesses which compete for the same markets as our companies which do not receive such subsidies. These revenue options particularly address the tax treatment of Blue Cross and Blue Shield Plans and the current tax exemption granted many health maintenance organizations (HMOs).

**David Senter**
**National Director**
**American Agriculture Movement, Inc.**

Mr. Chairman and Members of the Committee:

My name is David Senter and I am national director of the American Agricultural Movement, AAM. We represent family farmers in 34 states. In the ten years of our existence, we have provided a voice in Washington and around the country for one of America's most precious -- and dwindling -- resources: the American family farmer.

I want to discuss the impact of raising excise taxes on our members. It is no news to anyone that the family farm is in grave danger -- while our plight is not as fashionable in terms of news media coverage as it was a few years back, our situation has not improved. The combination of depressed prices for our products and high prices for the goods and services we need to purchase is continuing to drive the small farmer out of business. Foreclosures remain high; land prices low; and the continued importing of foreign commodities at prices below our cost of production is compounding the economic disaster.

It is with these factors in mind that I ask you to consider the effect of raising excise taxes on a segment of the population that is barely holding on to its economic lifeline. That effect is clear if you stop and think a moment about just what it is you are proposing to tax.

Cigarettes and cigars and smokeless tobacco are not manufactured in test-tubes. Tobacco is grown, grown in the soil by American farmers who, on average, own less than 500 acres of land. Raising excise taxes will indeed reduce consumption of tobacco products, and who will that hurt? The small farmer who is usually making just enough to keep his farm going and his family fed. A higher excise tax on tobacco is a lower income for America's tobacco farmers.

It's the same for alcohol. Barley, hops and grapes aren't made out of silicon chips -- they're grown, too, by farmers all over the country. And despite efforts by giant agribusiness concerns to centralize and control the crops, there are still plenty of small to medium-sized farms producing grain and fruit for use in alcoholic beverages. Raise excise taxes and you'll hurt them too....and eventually create a situation where every beer consumed in this country comes from Germany and every glass of wine from France, Italy or other wine producing nations.

Even farmers who aren't growing these crops are hurt by excise taxes. Every farmer in the U.S. uses gasoline in far greater amounts than urban or suburban Americans. Every farmer purchases car and tractor tires; every farmer is dependent on telephone services as the lifeline to the outside world. Every farmer is a consumer...and the ones we represent are not consuming hundred dollar dinners and thousand dollar wardrobes. That also holds true for the thousands of small rural shopkeepers who are especially vulnerable to the loss of revenue entailed by raising excise taxes.

As a representative of one of the most depressed sectors of the economy I can tell you that raising a tax which takes the same amount of money out of everybody's pocket -- no matter how rich or poor they are -- is un-American and unfair.

Don't console yourselves by thinking an increase in excise taxes is hidden and not felt by those who bear the greatest burden. You will be kicking people who are being kicked around enough. On behalf of what farmers there are left, we ask you to leave excise taxes out of this year's tax bill.

Thank you.

# STATEMENT

# SUBMITTED BY THE

# AMERICAN ASSOCIATION OF MUSEUMS

Mr. Chairman, members of the Senate Finance Committee, we appreciate the opportunity to submit a statement for the record. This submission is made on behalf of the American Association of Museums (AAM), and on behalf of this country's museum community. The AAM is an organization of over 10,000 members, including approximately 8,000 museum professionals and 2,000 art, history and science museums, historic houses, science and technology centers, acquariums, botanical gardens, arboretums, nature centers, zoos, children's museums, park museums and visitor centers.

On June 25, 1987, the staffs of the Joint Committee on Taxation and the House Ways and Means Committee released a set of options in connection with the responsibilities of the Congress under the 1988 Congressional budget resolution. You have announced, Mr. Chairman, that the Senate Finance Committee will use this options pamphlet as the starting point for considering various revenue raising alternatives.

The museum community understands the enormous difficulty of balancing budgets in the face of limited revenues and unlimited responsibilities. Museum directors and officers are continually confronted with very hard choices about what must be done and how must it be financed. For that reason, we are sympathetic with the task before you and your colleagues on the Committee and in the Congress, Mr. Chairman.

Our statement to the Committee focuses on four of the proposals contained in the staff option paper. We hope to demonstrate to you why these four options will cause such significant problems for the museums of this country and their visitors that the options should be rejected. We are, of course, fully aware that other businesses, organizations and individuals will point to different options, and argue forcefully that they ought to be rejected. Nevertheless, we are confident that the unique role of museums in this country and the very substantial impact of the four options on their short and long term financial health will persuade you to adopt other options for purposes of meeting your FY88 budget responsibilities.

Three of the four proposals that we believe will cause significant hardships for museums deal with reducing the current modest incentives for making contributions to section 501(c)(3) organizations, and are described in section IID of the staff options. The fourth proposal is contained in section IIF and suggests imposing an excise tax upon the investment income of exempt organizations. The three proposals dealing with the tax treatment of contributions presumably are directed towards individual taxpayers, but they have a serious economic effect upon nonprofit institutions. The fourth proposal, we believe, goes to the heart of the principle of tax-exempt status. In our statement we will first discuss the three proposals relating to tax deductions for charitable contributions, and then discuss the excise tax proposal.

The three proposals dealing with the deductibility of charitable contributions include the following:

1. reducing individual tax preferences such as the itemized deductions by 10% across-the-board;

2. setting a floor under aggregate itemized deductions equal to 10% of adjusted gross income in excess of $100,000 for married taxpayers filing jointly; and

3. limiting the computation of itemized deductions to the 15% tax bracket.

The staff options do not indicate what impact the three proposals will have upon charitable contributions to tax-exempt organizations in general, let alone what impact they will have upon museums. We do know, however, that charitable contributions make up about 14.5% of all itemized deductions. We also know that approximately 85% of all the items in museum collections throughout this country (as measured by value) were the result of gifts. Thus, we believe it is a reasonable assumption to conclude that revising the tax code to reduce the incentives to make charitable contributions has, at the very least, the potential to affect museums very adversely.

These adverse impacts have very real costs to the nation. To the extent charitable contributions of tangible personal property--the objects that make up the museum's collection--are discouraged, items of cultural, historical and artistic importance remain in private hands rather than public hands. To the extent charitable contributions of cash and investment property are discouraged, the care and safekeeping of our cultural and historical heritage, irreplaceable art and vanishing species of plant and animal life is jeopardized.

We believe very strongly that any increase in revenue that might occur because of the proposed restrictions and limitations on charitable contributions is more than outweighed by the losses to the public that such changes will provoke. More than one-half billion visits per year are made to our nation's museums. These visits are eloquent testimony to the vast benefits that accrue directly to the American people by encouraging gifts to museums. The value of these benefits may not be as easy to quantify as the additional tax revenue to be raised by the enactment of the staff proposals. Nevertheless, Mr. Chairman, we ask you to consider what the Museum of Fine Arts of Houston, the Bronx Zoo of New York or the Oregon Art Institute in Portland would be like if even a modest number of the objects in their collections were eliminated. Surely, depriving the American people of the pleasure, beauty and knowledge represented by those objects and encouraging their private ownership is an inequity at least equal to any perceived inequities in tax policy that the current law may cause.

The proposal to impose a 5% excise tax on the investment income of section 501(c)(3) organizations is worthy of consideration, according to the staff option paper, because all organizations that benefit from government expenditures should participate in the effort to reduce the federal deficit. The option paper points out, however, that the beneficiaries of tax-exempt organizations will be hurt as a result of the reduction in funds available for programs. We believe, Mr. Chairman, that these dry statements of arguments pro-and-con do not capture adequately the real impact of the proposal upon tax-exempt organizations nor the role of such organizations in serving public needs.

The AAM recently conducted a survey of a sample of its members to determine the relative importance of various sources of financial support for museums. Approximately 60 museums responded to the survey. Of those that responded, endowment income (which is essentially equivalent to investment income) represented between 10 and 20% of annual financial support. In the main, this income is used to fund museum operations. It is critical to the fulfillment of the tax-exempt purpose of the museum. Any reduction in investment or endowment income will reduce on a dollar for dollar basis the programs of the museums. This means shorter hours of operation, fewer exhibits, and reduced outreach programs for the members of the community with the least access to museums.

The basis for conferring tax-exempt status is to encourage non-governmental organizations to undertake activities in the public interest. Museums support vigorous enforcement of the tax-exempt rules and loss of tax-exempt status for any organization that fails to act in the public interest. We believe strongly, however, that to impose a tax--whether income or excise--upon organizations that are acting in the public interest is to establish a precedent that will cause long term harm to our country. A tax will create permanent uncertainty in the minds of employees, beneficiaries and benefactors about the ability of tax-exempt organizations to commit all their resources to accomplishing the goals for which the organizations were established. Inevitably, the human and financial resources necessary to accomplish these goals will shrink. The result will be, in the case of museums, a society that knows less about its past and thinks less about its future. We suggest that such a society is ill-equipped to meet the responsibilities of freedom and democracy.

Museums, as well as other section 501(c)(3) organizations, have been buffeted by many changes in the tax law in recent years. Changes in the tax rate structure and the new appraisal standards have created substantial uncertainty in the museum community. The inclusion of gifts of appreciated property in the minimum tax and the elimination of the deduction for non-itemizers have already begun to reduce museum support. While the full impact of any one of these, let alone all of them, is not yet known, the potential for harm to museums is clear. Another set of rule changes will increase the likelihood of undermining the financial health of museums, as well as all other nonprofit organizations.

In conclusion, Mr. Chairman, we believe the staff option proposals that we have highlighted in our statement will, if adopted by you and your colleagues, create a society that is less enlightened and less educated. In the long run, this will make it more difficult for the Congress to carry out its duties and responsibilities. We hope that we have persuaded you.

# STATEMENT

# FOR THE RECORD

# BY

# THE AMERICAN ASSOCIATION OF RETIRED PERSONS

The American Association of Retired Persons (AARP), represents the interests of 26 million persons aged 50 and over. AARP applauds Congress for adopting the FY 1988 budget resolution and offers the following comments on revenue raising options before Congress to reduce the federal deficit.

In the face of unsustainable federal deficits, the Association has maintained that any responsible deficit reduction strategy should include restoration of the federal revenue base to a fiscally prudent level, and this year is no exception. AARP believes that any overall deficit reduction program Congress adopts -- one in which revenue is an essential but not the sole component -- must recognize the past sacrifices made by various groups as well as equitably distribute the pain of any further deficit reduction efforts.

Finding the revenue sources to meet the revenue target in the FY 88 budget resolution represents a formidable challenge, but the revenue must be raised unless we are prepared to live with the consequences of unacceptably high deficits. The Association believes that any revenue package Congress adopts must be

- equitable and perceived as fair;
- conducive to economic growth; and
- easy to administer.

## I. RAISING REVENUE THROUGH INCREASED COMPLIANCE

The Association believes that increasing compliance is a priority method of raising revenue; one to be fully explored before turning to other alternatives that raise the taxpayers' burden. Approximately $100 billion in revenue still escapes taxation annually through noncompliance resulting from the underreporting of income, the overstatement of deductible expenses, the failure to file, or the failure to pay tax liabilities even when reported correctly. Improving compliance requires minimal federal outlays; few, if any, changes in current law; and it is especially appealing to the bulk of honest taxpayers. Given the enormity of uncollected taxes and the need to reduce the deficit, the Association recommends that the committee address the noncompliance gap as the first step in any deficit reduction strategy.

Congress previously enacted legislation in 1982, 1984, and 1986 to combat noncompliance. These laws, which provided for improved information reporting and stiffer penalties, enhanced IRS' arsenal of weapons against noncompliance.

While these tools lessened the noncompliance rate somewhat, they only attacked one aspect of a multifaceted noncompliance problem. As a result, the noncompliance rate did not shift dramatically downward. To effectively reduce taxpayer noncompliance still further, the percentage of returns currently audited must rise. The reduced likelihood of an audit emboldens those who disregard the law; and those who do not comply with the law because they do not understand it escape audit detection as well.

In 1976, 2.5 percent of all taxpayers filing a return were audited. But, by 1986, audit coverage declined to 1.1 percent. From 1980 to 1985, the IRS reduced its staff in response to budget cuts. As a result, the estimated compliance rate dropped from 86.5 percent in 1980 to 81.5 percent in 1985. An understaffed IRS simply could not keep pace with the workload or the ever-increasing complexity of the tax code.

Increasing audit coverage brings in additional revenue in two ways: by errors discovered in the audit process and by increased compliance attributable to taxpayer concern about a possible audit. The return on each dollar invested in audits is estimated at $9 or $10. (Some suggest a figure as high as $20 for each dollar invested.)

AARP also believes the President's budget proposal to increase IRS examination and enforcement staffs should be considered. They represent an excellent beginning for a larger and more extensive campaign against noncompliance. We urge the committee to move toward reinstating an audit rate of 2.5 percent.

The Association recognizes that such increased enforcement has its costs. These include additional personnel and equipment, the possible diversion of some personnel from other productive activities, and the inconveniencing of taxpayers who comply with existing law, but who may have to spend more time justifying their returns. Furthermore, some taxpayers view additional enforcement as harassment or an invasion of privacy. Nonetheless, the revenue generated justifies the increased audit rate.

Increasing the audit arm and enlarging the battery of enforcement weapons is not sufficient, however. Assisting honest taxpayers is also important in improving compliance. It represents a logical investment with beneficial long term dividends.

The IRS needs to improve its accessibility and also consistently provide taxpayers with accurate and understandable information. A recent General Accounting Office report points out that about 40 percent of calls to IRS information service lines were not answered on the first attempt. More significantly, 15 percent of the callers received correct but incomplete answers, and 22 percent of the time the responses were incorrect.

Taxpayers tend to lose confidence in our tax system if they cannot get a timely or accurate reply to a question about tax law from the very agency responsible for enforcing that law. AARP's presidential award winning Tax Aide Program for the Elderly illustrates clearly the benefits of providing taxpayers with information and assistance in preparing tax returns.

One final point on noncompliance relates to the extensive tax code revisions of the Tax Reform Act of 1986 (TRA). Given the extent of these changes, IRS must quickly develop a comprehensive plan for educating the public about the new law. If this is not done in a timely manner, some taxpayers will face significant 1987 tax preparation problems, and, even worse, unforeseen revenue could be lost. (Some taxpayers may even be hard pressed financially to meet an unanticipated tax bill.)

## II. BROADENING THE TAX BASE

The Association supported the Tax Reform Act of 1986 because on balance it benefits the majority of taxpayers and promotes greater equity. However, passage of the Act has restricted the potential use of the tax code for further deficit reduction efforts. Now, fewer preferences and "loopholes" remain as candidates for elimination. Moreover, reduced rates devalue the intact preferences. Additionally, some in Congress believe that further tax code revisions should be avoided until the ramifications of the TRA can be evaluated.

AARP has consistently supported efforts to broaden the tax base to eliminate or restrict tax subsidies of more limited value. The Association urges the committee to re-examine the code with an eye towards further refining existing preferences after TRA. Potential changes in corporate tax provisions include restricting the current tax treatment of advertising expenses and the tax advantages of limited partnerships. On the individual side, Congress may want to tighten up the law on home equity loans so as to eliminate perceived inequalities as well as to protect persons against unscrupulous lenders taking advantage of this provision.

## III. EXCISE TAXES

A lively debate has emerged regarding increased excise taxes. Many people object to them as a major revenue raiser because of their regressive nature. While excise taxes generally tend to affect low income persons more than the rest of the population, the consumption of cigarettes, beer and wine varies within income classes. Thus, the increase will hit heavy consumers harder than moderate users, and non-consumers will be spared entirely. Also, the so-called "sin taxes" are essentially discretionary purchases, and taxpayers can reduce consumption to avoid a heavier financial burden.

Historically, the United States has relied on excise taxes as a significant revenue source. During the 1950's excise taxes raised about 14 percent of all federal revenues. After the enactment the Excise Tax Reduction Act of 1965, revenue from excise taxes began declining. By 1984 the revenue raised amounted to only 5.6 percent of all federal receipts. Not only did Congress eliminate many federal excise taxes over the past 20 years, but it also failed to adjust the existing ones for inflation.

Because these taxes have not been raised sufficiently since 1951 to keep pace with inflation, consumers of alcohol, beer, wine and cigarettes have paid less tax on these products in real dollars. Meanwhile, the health related costs associated with their consumption have placed a strain on the federal treasury.

### A. ALCOHOLIC BEVERAGES

Under present law, federal excise taxes are levied at a non-indexed, flat rate on the production or importation of alcoholic beverages: distilled spirits, wine and beer. With one exception the federal tax on alcoholic beverages has remained constant since 1951. As a result, after adjusting for inflation, these taxes generate 40 percent less revenue today than in 1951.

Like many other Americans, older persons would prefer that "sin taxes" be increased before income tax rates are raised. AARP recommends that the distilled spirits tax be doubled to compensate for inflation; that the excise tax rates on wine and beer be based on alcohol content like the present distilled spirit tax; and then equalized with distilled spirits. Finally, we also suggest that any newly-established alcohol tax rates be indexed for inflation.

Studies show that higher alcoholic beverage prices discourage consumption, especially among the young. Alcohol abuse causes automobile accidents, cirrhosis of the liver, increased crime, increased domestic violence and increased family and personal stress. It also drains government revenue by raising federal medical costs, and it affects the economy through lost productivity.

### B. CIGARETTE TAX

The present tobacco product excise taxes are imposed as a flat, non-inflation adjusted rate on cigars, cigarettes, papers and tubes, snuff and chewing tobacco manufactured in or imported to the United States. The tax on "small cigarettes" generates substantially all of the federal revenue from excise taxes on this product class.

Like alcoholic beverage taxes, these taxes have been increased only once since 1951. As a result, the effective tax rate today is lower than in 1951. If the tax rate had been adjusted for inflation, then the cigarette excise tax would be 34 cents per pack instead of the current 16 cents.

AARP supports a doubling of the current tax on small cigarettes and the subsequent indexing to inflation of the new rate. Our members consistently have supported a cigarette tax rate increase for very much the same reasons that they endorse one for alcoholic beverages. They recognize that the product's price influences the level of consumption; higher prices deter smoking among the young especially and, to a lesser degree, among adults.

Over and above any increases, the Association urges Congress to permanently index new cigarettes tax rates. This change would eliminate the need for future ad hoc adjustments.

Cigarette smoking has been linked to numerous illnesses such as lung and related cancers, chronic lung diseases, and even premature births. Given these serious health problems and their related medical costs, smokers should help underwrite a greater share of the taxpayers' burden. Moreover, passive smoking poses health risks to nonsmokers. Finally, cigarette smokers have higher absentee rates than nonsmokers, which means a loss in productivity.

The Association recognizes that an increase in the cigarette tax rate, like one for alcoholic beverages, could be attacked as regressive. While a tax increase of this nature exacts a greater percentage of the disposable income of lower income taxpayers, the tax is placed on a discretionary item. Furthermore, the consequences of foregone consumption are beneficial to the taxpayer and to society.

## C. TELEPHONE TAX

The present 3 percent excise tax on local and long distance telephone service will expire on December 31, 1987. AARP recognizes that Congress may well need to extend the current tax. However, the Association would oppose any further increases in the individual rate regardless of how small.

In today's world, the telephone has become a necessary expenditure -- an essential for day-to-day living. The infirmed and homebound, usually the poorest among older Americans, especially rely on the telephone as their link with the outside world. Frequently, they forego other items in order to afford a telephone. These people and other low-income persons of any age would be hard hit by a telephone tax increase. If Congress decides to seek additional telephone tax revenue beyond an extension, we suggest increasing business rates above those for individuals and specifically targeting mobile phones for a stiffer rate increase.

## D. AIRPORT AND AIRWAY TRUST FUND EXCISE TAXES

The Association believes the committee should adopt the Administration proposal to extend the current taxes deposited in the Airport and Airway Trust Fund for two years. These taxes include an 8-percent tax on passenger transportation; a 5-percent tax on the domestic air transportation of property; a $3-per-person international departure tax; a 12-cents-per-gallon tax on gasoline used in noncommercial aviation; and a 14-cents-per-gallon tax on non-gasoline fuels used in noncommercial aviation.

The Administration proposal to impose a $1 tax on international air and sea travel could be substantially expanded and the revenue deposited in the general fund. While this does represent a departure from the trust fund earmarking principle, the Congressional Budget Office study on excise taxes indicates that an increase in the airline excise tax is mildly progressive as a percentage of family expenditures. This option would avoid unduly burdening low income taxpayers.

## E. SECURITIES TRANSFER EXCISE TAX (STET)

An excise tax on securities transactions has been suggested as a potential source of revenues. A transfer tax of this type was in place from 1918 until 1965, and is common in other industrialized democracies. The STET, which could be a simple one-half of one percent tax on the value of securities transactions, has the ability to raise significant revenues, up to $22.5 billion over a three year period. Moreover, the STET appears at first glance to be a progressive means of raising revenue, as the ability of individuals to engage in securities transactions depends primarily on income. However, the largest traders of instruments subject to the STET now belong to institutional investors, particularly pension funds.

A STET would impact on a pension fund in at least three ways. First, a STET would increase the costs of managing a pension fund. As transactions became more expensive, a smaller share of the fund's gross income would return to the fund on behalf of the fund's beneficiaries. Second, the STET would have a dampening effect on the investment practices of professional fund managers. Pension funds have experienced exceptional growth in recent years; this growth is largely the result of fund managers taking full advantage of favorable market conditions. Because of the importance of favorable pension fund performance to the nation as a whole, it would be unwise to create any disincentives to the management of such funds. Finally, a STET is expected to cause a reduction in the value of traded securities as investor interest in the purchase of securities declines. The biggest losers from the expected drop in stock prices would be institutional investors, particularly pension funds, and ultimately pension plan participants and beneficiaries.

## IV. ENERGY TAXES

Taxing energy products may become necessary in order to meet the revenue target. While energy taxes are large revenue raisers that promote conservation and reduce our foreign oil dependence, they also have distinctive drawbacks. Not only are such taxes regressive and inflationary, but they have uneven effects on different regions of the country and different sectors of the economy; and, in some cases, on different age groups.

## A. OIL IMPORT FEE

In 1982 the United States' oil imports declined to 28 percent, their lowest point in many years. For the next few years, oil imports remained around 30 percent. However, American consumers began using more energy when the per barrel oil price dropped markedly in 1986. The sharp price decline not only spurred oil imports but also wreaked havoc in oil producing states.

Supporters of an oil import fee argue it would lessen our foreign oil dependence, encourage domestic production and exploration, and promote conservation. Presumably increased domestic production would revive the sagging economies of the oil producing states.

Opponents of an oil import fee, on the other hand, point out that it is regressive and inflationary. Increased prices for petroleum (and even alternate energy forms) and the probable higher costs of petroleum-based products resulting from the tax hurt all consumers, especially low income persons. Furthermore, the increased production costs for energy intensive industries throughout the nation could raise the price of manufactured goods with substantial petroleum or petroleum-based contents, and presumably reduce our economic competitiveness.

An oil import fee would place a larger burden on the eighteen oil dependent states (mainly located in the Northeast and North Central regions) which are non-oil producers and which also lack energy resources. These states rely on petroleum for 60 percent of their energy needs. An oil import fee would saddle these states' residents with substantially higher heating bills.

Finally, critics contend that the net revenue potential of an oil import fee has been exaggerated. They note, for example, that the cost of some discretionary spending programs and, more importantly, inflation sensitive federal welfare and entitlement programs would rise to reflect increasing prices. Also, potentially smaller industrial profits from those energy dependent sectors of the economy, in turn, reduce federal income tax receipts.

The impact of an oil import fee upon the elderly is especially acute. While studies show that older persons consume less energy per capita than other Americans, they pay a larger proportion of their income for energy expenses than do younger persons. Conservation of energy is often an impractical solution because it endangers the more fragile health of many older persons who are uniquely affected by lowered temperatures in the winter or raised thermostats in the summer.

In the event Congress adopts an imported oil fee, it is imperative that safeguards be provided to protect the vulnerable elderly. Possible options include a rebate for home heating oil or some other targeted relief for the elderly poor, possibly through the Low Income Home Energy Assistance Program.

## B. GASOLINE TAX

Since a gallon of gasoline costs considerably less than it did several years ago, some believe the effects of an increased gasoline tax would be relatively painless. They point out that the federal gasoline tax has remained well below rates levied outside the United States. Additionally, a gasoline tax tends to treat different sectors of the economy more evenhandedly and would have relatively little effect on our international competitiveness. Also, the tax can be collected more easily than an oil import fee because a mechanism is already in place. Furthermore, the discretionary nature of some driving, especially for non-work related purposes, permits persons to control their tax burden somewhat. Finally, to the extent that some low income households do not own automobiles, the impact of the tax would be avoided.

However, like an oil import fee this option is inflationary, and regressive. Also, its impact is regionally disparate, disproportionately affecting those residing in the West and Southwest. Moreover, it infringes on a tax base traditionally used by states, which currently face the need for added revenue in order to provide programs and services curtailed by the federal government. In fact, 10 states already have raised their gasoline tax rates this year, and 2 others are considering it.

## V. INCOME TAX RATES

### A. DIRECT TAX RATE CHANGES

Despite the considerable and formidable announced opposition to such a move, some advocate raising revenue by adjusting the tax rates adopted in 1986. This change could be effected by either freezing temporarily the 1987 tax rates or possibly by increasing the new top rate.

At this time, the Association opposes any upward adjustment in the individual tax rates or changes in the current schedule of rates under TRA, especially for the bottom rate. A generalized rate hike would be most burdensome to the lower income taxpayer. Also, this change would contribute to taxpayer uncertainty and cynicism about the stability of the new tax rates.

While it may be possible to implement a rate hike in a manner that would protect those least able to pay, this option should not be considered except as a last resort. If tax rate changes are considered seriously, we would prefer increasing the top corporate rate or subjecting more individual income to the top tax rate as a more equitable means of raising revenue.

## VI. ADMINISTRATION'S REVENUE PROPOSALS

The administration's Fiscal Year 88 Budget proposal contains a number of revenue provisions which would raise around $39 billion over 3 years. AARP believes that some of these recommendations should be included in the committee's package.

### A. MANDATORY MEDICARE COVERAGE FOR STATE AND LOCAL EMPLOYEES

President Reagan proposes to extend Medicare coverage on a mandatory basis to all employees of state and local governments not otherwise covered under current law without regard to date of hire. As a result, effective January 1, 1988, employees and employers would become liable for the hospital insurance (HI) portion of the Federal Insurance Contributory Act (FICA) tax.

AARP has previously endorsed mandatory coverage of current state and local government employees under the HI program. Mandatory Medicare coverage of these employees would increase fairness in the program and improve health coverage.

Despite the fact that Medicare coverage is currently optional for state and local employees, over 90 percent of these employees eventually become eligible for Medicare even though they may have contributed very little to the system. Consequently, these employees who receive full Medicare coverage but do not pay the HI tax for their entire working careers are unfairly subsidized by other retirees who have worked under Social Security and paid the HI tax for their entire working careers. Imposing the HI tax on state and local employees would redress this inequity.

Extending the HI tax to state and local employees would likely improve health coverage for those 10 to 15 percent of state and local employees who never gain Medicare coverage and for those retired state and local employees who receive health insurance coverage from state and local plans. Evidence exists that Medicare provides more comprehensive health insurance coverage than state and local plans can afford for their retirees. Moreover, Medicare coverage is portable. State and local employees who change jobs and would lose eligibility for benefits under state and local plans would find Medicare coverage advantageous.

For the above reasons, AARP favors the proposal for mandatory Medicare coverage for state and local employees.

## B. FICA TAXES FOR CERTAIN EMPLOYEES

The administration suggests repealing various current law FICA tax exemptions. These proposals have been approved by the House Committee on Ways and Means. If these changes become law, effective January 1, 1988, wages received by Armed Forces reservists on active duty, certain earnings from family employment, and wages for specific types of agricultural employment will no longer be exempt from the FICA tax. Affected employees would be covered by Social Security and could earn coverage credit.

AARP supports universal Social Security coverage not only because it protects non-covered employees but also because it increases equity for covered wage earners. We hope the Committee will explore repealing other existing FICA tax exclusions that could be integrated into the revenue package.

## C. PENSION BENEFIT GUARANTY CORPORATION (PBGC)

The Pension Benefit Guarantee Corporation (PBGC) plays a valuable role in safeguarding the defined benefit plan promise for pension participants. Under current law, if a defined benefit plan is terminated by an employer with insufficient assets, then the PBGC guarantees payment of certain benefits. Part of PBGC's revenue comes from per-participant annual premiums, currently set at $8.50.

Due to a recent wave of terminations of plans with large unfunded liabilities, particularly in the steel industry, PBGC is operating at a deficit. Current minimum funding rules need to be tightened to help prevent a similar situation in the future. In addition, terminations for reversions need to be restricted, and any such terminations should include a higher excise tax and enhanced benefits for plan participants.

The current PBGC deficit requires more than funding reforms for the future. Therefore, a package of funding reforms should also be accompanied by an increase in the premium. A flat premium, reflecting the social insurance nature of PBGC, is preferred to a variable rate premium. In addition, a variable rate may be too burdensome in that it will require currently distressed plans and employers, unable to meet the higher payment obligations, into prematurely terminating a pension plan. A flat increase in the premium is recommended to help PBGC meet its benefit obligations.

## VII. ADDITIONAL SOURCES OF TAX REVENUE

### A. ESTATE TAX

The estate tax has become a decreasing source of revenue since the Economic Recovery Tax Act of 1981. Estate tax revenues fell from around two to less than one percent of federal revenues from 1980 to 1986. The 1981 changes included lowering the estate tax rate from 70 to 50 percent (the rate decrease was frozen at 55 percent until 1988 by the Deficit Reduction Act of 1984) and increasing the unified estate tax credit so that estates valued at up to $600,000 could escape taxation entirely. These changes are estimated to cost the government an estimated $46.4 billion in revenues from 1986 to 1991. The number of estates paying any estate tax at all has fallen from 35,148 in 1983 to 30,518 in 1985.

The committee may wish to consider modifying the estate tax system as part of a larger revenue package. An option which should be considered is to retain the present 55 percent top rate, rather than allowing the scheduled drop to a 50 percent top rate to occur.

Another revenue measure that should be included is a correction of a TRA-created employee stock ownership plan (ESOP) loophole. Originally intended as a provision to encourage sales of stock to employee stock ownership plans, the current loophole allows tax planners to assist their clients in avoiding payment of estate taxes. Current law, already tightened by IRS rules early this year, still permits estates owning stock in companies with ESOP's to sell the stock to the plans and exempt part of the proceeds from the estate tax.

The loosely drafted provision, never intended to have such broad application, or to result in large revenue losses, is expected to cost about $7 billion over five years. The ESOP provision should be amended to reflect its limited intent.

### B. LUXURY TAX

In the past, the United States has made limited use of the luxury tax as a revenue source, and also has levied excise taxes on a wide range of goods considered luxury items. A luxury tax could be reinstated on the purchases or resales of selected items above a certain price: boats, airplanes, automobiles, furs, jewelry, electronic equipment and entertainment devices. The tax could be a flat percent or apply to the cost in excess of specified thresholds; the rate of taxation would be determined by the revenue to be raised.

Some find a luxury tax attractive tax because it primarily affects upper income consumers and is levied on discretionary purchases. The Association recognizes the limited revenue such a tax could raise, but we recommend that Congress examine it as a way of shielding lower income taxpayers from additional tax burdens, and because it would enhance the progressivity of a total package of revenue increases.

## C. CONSUMPTION TAX/VALUE ADDED TAX

Various people advocate a consumption tax on goods and services rather than income. A value added tax (VAT), one type of a consumption tax has been widely recommended. A substantial revenue raiser, this tax has various drawbacks that counterbalance its tremendous revenue potential. These include its regressivity, its hidden nature, the impact on those with a fixed income, and, finally its inflationary nature. A consumption tax seriously departs from current tax policy and also would be extremely difficult to implement. The Association strongly rejects efforts to reduce the deficit through a consumption tax.

## VII. CONCLUSION

The Association has in the past supported responsible revenue raising packages such as the Tax Equity and Fiscal Responsibility Act and the Deficit Reduction Act, as well as the base broadening provisions of TRA. These bills have helped restore lost revenue in an equitable and efficient manner. Continued deficit reduction is essential.

The options cited in the testimony which the Association supports exceed the revenue target mandated by the FY 88 budget resolution. We believe they are equitable, pro-growth and manageable alternatives.

AARP looks forward to working with this Committee as it develops a revenue raising package that we hope represents both sound tax policy and social policy goals.

# STATEMENT
# BEFORE
# THE SENATE COMMITTEE ON FINANCE

# ON

# REVENUE-RAISING OPTIONS

BY

NORMAN SHERLOCK
PRESIDENT AND CHIEF EXECUTIVE OFFICER
AMERICAN BUS ASSOCIATION

AUGUST 11, 1987

I appreciate this opportunity to comment on the Administration's revenue increase proposals contained in the President's Budget for Fiscal Year 1988 and the revenue options presented for consideration in the Joint Tax Committee's staff pamphlet published on June 25, 1987. The American Bus Association ("ABA" or "the Association") represents more than 3,500 companies involved with bus regular route, tour and charter, airport and commuter services and in businesses which are related to travel and tourism.

## I. Administration and Joint Tax Committee Proposals

In its fiscal 1988 budget proposal, the Reagan Administration has outlined a number of revenue raising proposals, including the repeal of all existing Highway Trust Fund excise tax exemptions. Exemptions from excise taxes, particularly the 12 cent per gallon diesel fuel excise tax exemption, are essential to maintaining a financially healthy and viable intercity bus industry as part of the national transportation network.

The amount that would be raised by eliminating this exemption - $30 million - is not enough even to warrant an asterisk in the national budget, but it is important to thousands of small, struggling bus companies. For many, the savings represent their profit. A quick look at the newspaper over the last six months illustrates the fragile economic condition of the bus industry. The recent buy-out of the financially distressed Trailways Lines, Inc. is further indication of the precarious economic condition of the bus industry.

According to the Interstate Commerce Commission, operating revenue and ridership of 10 of the largest bus companies substantially declined in 1986 compared to 1985. Operating revenues fell 10.5 percent and passengers carried fell 17.7 percent. Net income dropped by $10.2 million to $35.1 million.

The American Bus Association urges that Congress again reject any proposal to repeal the intercity bus industry's exemptions from excise taxes.

In addition, included among the revenue raising options formulated by the Joint Tax Committee is a proposal to increase excise tax rates. Specifically, possible proposals include: (1) increasing by 5 to 10 cents per gallon the excise taxes on all motor fuels used in highway uses; and (2) indexing the taxes for inflation using the Consumer Price Index after the tax increase is implemented. The options also include a proposal that diesel fuel continue to be taxed at current rates.

The revenue raising options also include a proposal that would require that wholesale dealers collect the diesel fuel excise tax. Under current law, the tax is collected and paid at the retail level, and bus operators are required to pay the full 15.1 cents per gallon tax and then file for a credit or refund of 12 cents of the tax or for the full amount of tax. ABA urges that the efficiency of administration could be improved by requiring bus companies to pay only the tax that is lawfully due, thereby eliminating the necessity of filing for a refund or credit.

As an initial matter, ABA objects to an increase in highway user taxes for non-transportation purposes. It should be noted that the highway program has not contributed to the deficit. The American Bus Association opposes any increase in the diesel fuel excise tax. Dedicated Highway Trust Fund money should not be diverted, as these monies are needed for road and bridge repair and construction.

## II. The Intercity Bus Industry Plays a Vital Role in Our Nation's Transportation System

As outlined below, the intercity bus industry can ill afford an increase in taxes. ABA maintains that an increase in the diesel fuel excise tax is regressive, as an increase in the cost of intercity bus transportation will disproportionately impact passenger service which is characteristically provided to lower income and rural area travelers.

Congress has repeatedly expressed its support for the transportation policy goals embodied in the excise tax exemptions as evidenced by the rejection of last year's proposal to repeal the excise tax exemptions made by the Administration. For these and the following reasons, the American Bus Association urges that Congress again reject the proposal to repeal these exemptions and to reject the proposal to increase the diesel fuel excise tax.

Historically, Congress has urged the use of private intercity bus transportation. The Energy Tax Act of 1978, the Highway Revenue Act of 1982, and the Tax Reform Act of 1984 all contain provisions exempting intercity buses from all or part of the diesel fuel excise tax and from other highway user taxes.

Most recently, Congress acted to extend these exemptions as part of P. L. 100-17, the Surface Transportation and Uniform Relocation Assistance Act. During consideration of this Reauthorization Act, the House and Senate tax writing committees considered the question of repealing or reducing these exemptions in order to raise revenue for highway and transportation programs. They decided that there was no need to take this step for either revenue raising or for tax equity reasons.

This national policy stems from Congressional recognition that the intercity bus industry plays a unique and vital role in our nation's transportation system. Private intercity bus operators must compete with subsidized mass transit operations and other subsidized forms of transportation for tour and commuter passengers.

The Office of Management and Budget estimates that the repeal of all existing highway excise tax exemptions would yield $800 million in increased receipts to the Highway Trust Fund in fiscal 1988. In regard to exemptions extended only to the bus industry, the Congressional Budget Office estimates that repeal would yield actual additional revenues of only $100 million in fiscal year 1988, the bulk of which is attributable to public transit. CBO estimated last year that the elimination of exemptions for the private intercity bus industry would provide only a very small portion of that figure -- approximately $30 million. Clearly, the excise tax exemptions extended to the intercity bus industry are not large revenue losers when measured in terms of the federal budget.

More than 375 million passengers ride intercity buses annually. In comparison with other modes of transportation, intercity buses carry far greater proportions of senior citizens, students, military personnel, and women. An income profile of intercity bus passengers reveals that 58 percent of them have annual family incomes of less than $15,000.

Of the approximately 12,000 points in the United States served by intercity bus service, an estimated 11,000 are not served by any other form of intercity transportation. Based on this information, it is clear that an increase in the diesel fuel excise tax would disproportionately impact rural communities and low income socio-economic groups.

We also wish to point out the energy conservation incentive provided by the diesel fuel excise tax exemptions. Intercity buses are the most fuel efficient from of intercity travel based on passenger miles per gallon of fuel consumed. To the extent that people can be encouraged to utilize intercity bus transportation rather than to drive personal automobiles, energy conservation is achieved. The excise tax exemption allows intercity bus operators to offer low fares which give an alternative to more energy intensive forms of transportation. Any increase in the diesel fuel tax would similarly impair the bus industry's ability to provide low cost transportation. It should be noted that the intercity bus is roughly three times more fuel efficient than Amtrak and six times more fuel efficient than commercial air transport.

Travel and tourism businesses rely heavily on intercity bus industry to bring them business, and for many of those businesses it is a critical lifeline. A ten percent decrease in bus ridership would cost these businesses close to $1 billion in revenue annually. As a further result, unemployment would increase dramatically, particularly among the minorities, women and youth who are heavily employed in the travel and tourism industry.

## III. Private Bus Companies Receive No Direct Federal Subsidy But Must Compete Routinely with Federally-Subsidized Entities.

The exemptions are the only subsidies which the intercity bus industry receives from the federal government. However, the intercity bus industry must compete with other modes of transportation which are the beneficiaries of huge federal subsidies. Specifically, intercity bus operations must compete for passengers with Amtrak and the airlines. Amtrak is directly subsidized at a rate of approximately $35 per passenger. The airlines are subsidized at a rate of approximately $9 per passenger, according to government studies, and have enjoyed large subsidies and favorable tax treatment in past years. Last year, the Administration estimated that the current 12 cent per gallon diesel fuel tax exemption amounted to an indirect subsidy of only 8 cents per passenger for the intercity bus industry.

Additionally, repeal of the bus-industry exemptions or an increase in the excise tax rate would further harm the competitive position of the private intercity bus industry vis a vis public transit authorities if it were not applied to them also. Public transit authorities are increasingly competing with private bus companies on commuter routes and in charters and tours. They enjoy tax exemptions due to their status as governmental entities and also receive large subsidies from the Federal government. A new subsidy, enacted as part of the Surface Transportation Assistance Act of 1982, has provided public mass transit authorities with revenues equal to 1 cent of the per gallon tax on motor fuels; this amounts to more than $1 billion from taxes imposed on private highway users, including private intercity bus companies. The proposed repeal of these exemptions or an increase in the tax rate would place our industry at a greater disadvantage than ever before.

## IV. Proposal to Change Collection of Diesel Fuel Excise Tax.

Under current law, the diesel fuel excise tax is generally imposed on the sale of fuel by a retail dealer to the bus owner or operator. Under an exception created by the 1986 Tax Act, retail dealers may elect to have wholesale distributors collect and pay the tax when the diesel fuel is sold to the retailer. The Joint Tax Committee options include a proposal that would make the election to collect the diesel fuel excise tax on sales by wholesale dealer mandatory for all sales.

Under current law, ABA members must pay the full 15.1 cents per gallon tax upon purchase or use of the fuel, and must later file for a refund or obtain a credit. Many ABA members experience extensive delays in obtaining their refunds.

ABA supports efforts to improve the efficiency of the collection and administration of the diesel fuel tax. However, ABA urges that increased savings and efficiency could be achieved by requiring bus owners and operators to initially pay only the tax which is lawfully due on the purchase of the fuel and not impose on the bus owner or operator the added burden of a claim for refund. These procedures would eliminate the extensive and unjustifiable delay experienced by bus owners and operators in receiving their refunds. Such a move would also eliminate the IRS' administrative burden of processing the claims for refund and tax credits.

## V. Conclusion

The repeal of the intercity bus industry's exemptions or an increase in the diesel fuel excise tax, in conjunction with the effects of deregulation in the industry, and continuing liability insurance problems, would have a serious financial impact on the private intercity bus industry. Many intercity bus operators are small business people and their businesses would suffer from the financial burden of an increase in excise taxes.

The American Bus Association urges the Committee and the Congress to reject the Administration's proposal to repeal these excise tax exemptions and the Joint Committee proposal to increase the diesel fuel excise tax. The ABA supports the alternative proposal that diesel fuel continue to be taxed at current rates.

Comments of the

AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION

to the

COMMITTEE ON FINANCE

UNITED STATES SENATE

on

Deductibility of Advertising Costs

July 16, 1987

The American Newspaper Publishers Association (ANPA) is a non-profit trade association, representing nearly 1,400 newspapers. ANPA members account for about 90 percent of U.S. daily and Sunday newspaper circulation. Many non-daily newspapers also are members.

ANPA opposes any revenue proposal which would limit the tax deductibility of advertising costs as a normal business expense. Discrimination against advertising among the many costs of doing business would be unwise public policy. Government action which discourages speech, including commercial speech, is contrary to sound basic concepts in our society.

## DISCRIMINATION AGAINST ADVERTISING EXPENSES

Section 162 of the Internal Revenue Code provides for the full deductibility of ordinary business-related expenses. Proposals to disallow a portion of advertising expenses as a business deduction incorrectly assume that advertising costs are not legitimate business expenses and arbitrarily single out advertising from other business costs for unfavorable, or less favorable, tax treatment. Businesses that sell retail consumer products would directly face the impact of such proposals; businesses that do not sell consumer products would be relatively unaffected.

Advertising sells consumer products. Without advertising, sales volume falls. Government action to make advertising more expensive for businesses likely will result, especially in the first year, in reduced advertising. Such action is likely to lead to reduced product sales, to act as a depressant on local economies and to foster job losses.

## EFFECT ON NEWSPAPERS

Newspapers, like other businesses, would find their own advertising more expensive under such proposals, but the more severe burden on newspapers would come from the reduced revenue base which would result. Retail advertisers, especially in the first year, likely would decrease their advertising linage rather than attempt to absorb the increased tax burden. They would be hard-pressed to spend more after-tax dollars on advertising than they had budgeted. Because newspapers depend primarily on local retail advertisers, reduced advertising cost deductions would severely affect newspapers.

Newspapers with reduced advertising revenues must cut their own costs. Publishers would be forced to consider such options as reducing the local news staff, reducing the number of pages published, and ending delivery in outlying parts of the circulation area. The most vulnerable newspapers would be those with marginal profits in competitive urban or suburban markets, and dailies and weeklies publishing in communities with already depressed economic conditions.

The contention that the benefits of advertising extend beyond the year of the expenditure is false. Studies by the Newspaper Advertising Bureau indicate most advertising messages are forgotten very rapidly. A message that is not consciously remembered may still have effect but only when it is reinforced through repetition. In addition, most newspaper advertisements are placed by local retail merchants who are interested in moving products within the day or week that the ad appears. A check of any newspaper issue will show a preponderance of "sale" ads over "institutional" ones. There is little if any residual impact from the kind of retail price advertising which is the predominant revenue source of local general circulation newspapers.

Readers use the newspaper as a daily catalogue of merchandise, services, comparative prices, sales and style information. Because of this, successful newspaper advertisements reflect the same sense of immediacy that exists in the news columns. The job hunter searches the classified advertisements with the strongly focused purpose of finding employment, now. Likewise, the reader in the market for a new suit will study the newspaper's advertisements to get ideas on the specifics of style and pricing before going shopping. Grocery, drug store and many other newspaper advertisements are aimed at comparison shoppers. The benefits derived from such advertising clearly are realized in the short term.

## ATTEMPT TO LIMIT FREEDOM OF COMMERCIAL SPEECH

ANPA is concerned about any governmental action which could discourage speech, including commercial speech, in a free society.

Limiting advertising expense deductions would constitute a governmental action reducing, in practice, the level of commercial speech and the flow of information to consumers in our society. Like proposals to deny the deductibility of advertising for some lawful products, this proposal also offends the free speech concepts valued by an informed citizenry in a free society dependent upon a free flow of information.

## CONCLUSION

There are other reasons why a limitation on advertising costs as tax deductible business expenses would be poor public policy. These include the administrative difficulties in defining "advertising," the contrary nature of such action in relation to current tax accounting principles, unfairness between businesses which must advertise heavily and those which advertise little or none, and its effect on competition. But ANPA's central concerns have been explained above. For all of these reasons, ANPA urges the Congress to reject any proposal to limit, deny or delay the deductibility of advertising expenses.

# WRITTEN COMMENTS
# OF
# RICHARD HOLLERITH, JR.
# AND
# ROBERTA NIELSEN FOR AMERICAN SECURITY BANK, N.A., CONSERVATORS OF THE ESTATE OF VIRGINIA HOLLERITH
# TO THE
# COMMITTEE ON FINANCE
# UNITED STATES SENATE
# JULY 16, 1987

## H.R. 2636
## Sec. 114(g)(2)(D)
## Retroactive Application of Generation-Skipping Tax to Estate of Individual Mentally Incapacitated Since February 1986

In accordance with the instructions set forth in the Committee's Press Release #G-3 of June 17, 1987, the following written comments are submitted by the conservators of the estate of Virginia Hollerith, an elderly maiden lady whose will provides for the creation of trusts for the benefit of her many nieces and nephews and their children.

Under the Internal Revenue Code of 1986 a federal estate tax will be imposed with respect to the transfer of Miss Hollerith's estate on her death, but no tax would be imposed on the ultimate transfer of income and principal to her grand nieces and nephews by reason of her mental incapacity since February of 1986, when she suffered a stroke. The proposed amendment of section 1433(b)(2)(C) of Public Law 99-514 (enacted into law October 22, 1986), specifically section 114(g)(2)(D), lines 14, 15, and 16 on page 440 of S. 1350, would change this result by causing a generation-skipping tax to be imposed, notwithstanding Miss Hollerith's continuous inability since before the date of enactment of the 1986 Act to change her will or otherwise dispose of her property. Ironically, the proposed amendment would impose no additional tax had Miss Hollerith died before January 1, 1987. Indeed, this would be true even if she had changed her will after September 25, 1985, the date that the proposed amendment seems to assume that this elderly lady should have become aware that Congress was contemplating enactment of a new generation-skipping tax. Moreover, the effective date provision which it is now proposed be changed remained unchanged from the date H.R. 3838 was introduced on December 3, 1985, until it became law on October 22, 1986.

We respectfully submit that it is extremely unfair for the Congress to impose transfer taxes that have any retroactive effect, and that this would be particularly true if those taxes were imposed with respect to transfers under very old wills of elderly individuals who prior to the effective date of the new law became mentally incapable of changing those wills. Indeed, it is bad enough to assume that such individuals were or should have been aware of congressional committee staff proposals which might result in the double taxation of their estates, but it would be especially egregious to impose a second tax retroactively, after those individuals were unable to change their wills and avoid the tax, except by dying before January 1, 1987, particularly when the effective date language of the new law remained unchanged from the time it was first introduced, thus leading anyone examining that language to conclude that the new tax would only be imposed prospectively.

For the reasons stated, we respectfully urge the Committee to delete the language which appears on lines 14, 15, and 16 of page 440 of S. 1350 as introduced in the Senate on June 10, 1987, and to report that bill to the Senate without that language.

The American Society of
Mechanical Engineers

Suite 216
1825 K Street, N W
Washington, DC 20006-1202
202-785-3756

August 14, 1987

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
Unites States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

As the Committee on Finance considers the FY 1988 budget reconciliation bill, the American Society of Mechanical Engineers (ASME) urges your consideration of Senator Moynihan's proposal, S. 39, which would make permanent the current law, Section 127, exclusion from taxation for employer-paid tuition assistance. Section 127 is due to expire on December 31, 1987, and we respectfully ask that you incorporate the language of S. 39 into the reconciliation bill. We also request that this letter be made part of the record of hearings held by the Committee on revenue-raising options on July 15, 16 and 17.

At a time when Congress is examining alternative policies for enhancing the nation's competitiveness, we believe that government policy should provide adequate incentives for continuing education and retraining. As a national organization with over 117,000 members, ASME is particularly concerned about the ability of engineers to stay abreast of rapidly changing technology. Our members are vitally concerned about updating their technical knowledge to maintain their jobs or to deal with job displacement due to a changing economy. Therefore, expiration of Section 127 will restrict the ability of workers to modernize and update their job skills.

If this nation is to prosper economically and compete effectively in the international marketplace, Congress should actively promote individual employee initiative and efforts to improve their job skills. Employee educational assistance benefits are especially effective incentives for upgrading the abilities of U.S. workers at a very low cost in terms of tax revenues.

We hope you agree that by incorporating S. 39 in the FY 1988 budget reconciliation bill, confusion and concern among employers and employees over tax liability for worker education will be dispelled, and permanency can be accorded to this popular training incentive.

Sincerely,

Richard Rosenberg

Richard Rosenberg, P.E.
President

# STATEMENT OF ELISSA MATULIS MYERS, CAE

DIRECTOR OF MEMBER SERVICES

AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

SUBMITTED FOR THE RECORD TO THE

SENATE FINANCE COMMITTEE HEARINGS ON BUDGET RESOLUTION

JULY 15, 1987

Mr. Chairman and Distinguished Members of the Committee:

I am Elissa Matulis Myers, CAE, Director of Member Services for the American Society of Association Executives, located in Washington, D.C. ASAE is a not-for-profit tax-exempt society representing the professional interests of 15,000 men and women who serve as key executives of the major trade and professional associations in the United States. ASAE serves three primary purposes. We seek to enhance the professionalism of our association executive members; to improve the performance of the voluntary membership organizations they represent; and to assist these executives and their organizations in dealing effectively with public policy issues that serve the broad needs of society.

It is with the latter two missions that I am concerned today.

Mr. Chairman, ASAE recognizes the important mandate you have to raise additional revenue in order to meet the fiscal demands of our society. We have the greatest respect for the fine and innovative thinking that produced the document describing revenue raising options that you are considering here today.

We are concerned in particular with two of the three options you have proposed that seek to raise funds from exempt organizations. In one provision, it has been suggested that trade association investment income and non-exempt function income including interest, dividends, royalties, rents and other investment income that is currently tax-exempt become taxable as unrelated business income. Second, it has been proposed that investment income of all exempt organizations under Section 501(a) be subject to a 5% excise tax.

We are particularly interested in the impact of those provisions on trade associations, professional societies, and similar organizations represented in the ASAE membership.

We recognize that, on first analysis, it would appear that both of these measures might serve to generate additional federal income. Our research indicates that the 7,500 associations represented by ASAE generate on average 6.4% of their annual income from investments, an average of just over $150,000. That average investment earning, spread over the 7,500 associations represented by ASAE would indicate a potential taxable pool of $1,125,000,000.

A 5% excise tax on that sum would appear to generate an additional $56,250,000 in federal revenue.

However, that income gain is an illusion.

The proposals I have mentioned are likely to have one of two equally undesirable effects.

First, and perhaps of paramount importance, associations will be forced to scale back their activities in order to meet the demands of the new tax burden. The trade and professional associations represented within the ASAE membership are engaged in a wide variety of important activities working to solve both the problems of the nation and the problems of the industries and professions they represent.

They are joining private sector initiative to your outstanding efforts to foster the well being not only of their members but also of society at large.

The American Association of Advertising Agencies, for example, in addition to helping to educate and uplift its members also sponsors The Media Advertising Partnership for a Drug Free America -- a 3 that enlists at least $500 million annually of free media time and space to help fundamentally reshape social attitudes about illegal drug use -- to unsell illegal drugs.

The American Bar Association has a wide ranging educational program designed to educate all segments of the American public about the Constitution and its unique role in the nation's history, including an outstanding PBS series that will air this fall, a national mock trial program, and much more.

After a member of the Florida Independent Automobile Dealers Association noticed a full, unsafe looking school bus being driven in Tallahasee, the association decided to raise funds to purchase a safer school bus for the battered and abused children of the Lighthouse Childrens Home. The initial program launched an annual effort that in 1986 marshalled $80,000 in donations for a down payment on a new Education and Recreation Building.

A National Association of Broadcasters program, The Work Resources and Retraining Initiative, is an effort by the NAB and local broadcasters to mobilize community resources to meet the challenge of assisting displaced workers from declining industries to obtain work skills and meet the needs of the technological workplace.

These are just a few examples of the literally tens of thousands of ways that associations and societies are working with you to solve our problems.

To the extent that they are fiscally hampered from carrying on that important work, the nation will suffer. It is even possible that increased government funding will be sought to fill the breach. Or, to put it more simply, an additional tax on the nation's trade and professional associations is likely to result in a shift in burden from associations to the federal government, and represents therefore a false economy. In some cases, those important public services may not be filled at all. In all cases, there will be a time lag, as society restructures to fill the void.

Second, as Gilbert Grosvenor from the National Geographic Society stated at the Unrelated Business Income Tax Hearings last week, recognizing the critical importance of their mandate, associations will restructure themselves in order to find a way to fund their activities. It is highly unlikely that they will permanently eliminate one or more important activities as a result of reduced funding.

Rather, in response to the significant increase in the cost of conducting their good works, the average association will increase dues and or fees to members.

Since funding for the important work of trade and professional associations comes from America's for-profit companies and individual professionals, the cost of participating in the associations to these members will increase.

While dues paid to a purely social or recreational club may be discretionary and is often a non-deductible expense to the taxpayer member, membership in trade associations and professional societies generally represents a necessary business expense or a charitable contribution, and in fact, dues and fees are generally deductible.

The net effect of the two proposed provisions, then, will be to transfer the source of federal revenue dollars from individual and corporate returns to associations rather than generating additional federal dollars.

What we imagine you will also want to consider is that the revenue generated at either the average tax rate under which the association investment income will be taxed or at the proposed 5% excise tax is generally considerably lower than the normal corporate or individual rate.

It is probable that the net revenue effect of the two provisions may in fact have the unexpected and unintended effect of an eventual decline in federal revenue.

It should be noted, too, that a subcommittee of the House Ways and Means Committee just concluded its extensive hearings this past week looking into the tax treatment of exempt organizations in general. It would seem more timely to await the overall recommendations of this important group before making adjustments in this area at this time.

We recognize the importance, however, of your efforts, and believe we can be helpful.

Associations stand ready and able to assist the federal government to more efficiently accomplish many of its programs by bringing to bear the extensive and effective collective membership power they have available. Associations are represented in considerable numbers among those organizations cited by the current Administration for excellence in private sector initiatives.

Many more are actively engaged in such worthy endeavors to serve the broad needs of society, and still more will volunteer to step in where a need can be identified.

America has long sought solutions to its critical problems and emerging opportunities through the collective efforts of its citizens organized into effective association units. We urgently appeal to you to consider once again strengthening this most valuable of national resources, rather than further taxing its strength. Please don't diminish the ability of associations to work with you as an important ally by taxing their passive income.

Thank you for your great courtesy in allowing me time to share my views with you today, and for your outstanding efforts to address the complex national agenda.

### STATEMENT OF

### THE AMERICANS FOR SUBSTANCE ABUSE PREVENTION AND TREATMENT

Mr. Chairman and Members of the Committee, in 1951, federal excise taxes on all alcoholic beverages were raised to help finance the Korean War effort. Taxes on distilled spirits were increased in 1985 -- 34 years later -- but the excise taxes on beer and wine remain unchanged.

The Americans for Substance Abuse Prevention and Treatment (ASAPT) believe it is time to equalize taxes on all alcoholic beverages to finance another war. The war on alcohol and drug abuse in America. Listed are some important figures for the Committee's consideration:

Alcohol Toll on Human Lives and the Economy

- Approximately 15 million Americans, including 3 million adolescents suffer from alcoholism or problem drinking.
- In a Gallup Poll, 81% of those asked said alcohol abuse is a major national health problem.
- Nearly three times the number of Americans killed in Vietnam die each year of alcohol abuse or alcoholism. Alcoholism shortens life expectancy by an estimated 10-15 years.
- More than 30 diseases are caused or aggravated by alcohol abuse including: pancreatitis, esophageal cancer, peptic ulcer, cirrhosis of the liver, tuberculosis, endocrine disorders and birth defects.
- More than one-half of all motor vehicle fatalities and deaths from falls or fires involve alcohol abuse.
- Alcohol abuse costs the nation, drinkers and abstainers alike, a total of $120 billion annually in lost productivity, health and medical care, crime and violence, sick leave and social welfare.

- Alcohol abusers utilize a disproportionately high share of health insurance and Medicare benefits, thus driving up cost for all persons.

The present need to generate additional funds for alcohol and drug abuse and other health-related programs is particularly acute. The enactment of the Balanced Budget and Emergency Deficit Control Act of 1985 and other budgetary constraints is expected to result in substantial cutbacks in appropriations for national health programs, including Medicare and the National Institute on Alcohol Abuse and Alcoholism (NIAAA).

To offset the effects of such cutbacks, the Americans for Substance Abuse Prevention and Treatment supports a tax increase on beer and wine as a means of maintaining adequate funding levels for NIAAA, state block grants, alcohol prevention programs in schools, alcoholism and drug abuse treatment and other health care programs, such as Medicare and Medicaid.

The simplest way to increase taxes on beer and wine would be to equalize the tax rates for all alcoholic beverages. Adjusted for alcohol content, beer is currently taxed at one-fourth the rate of distilled spirits, and wine is taxed at one-seventeenth the rate. The current federal excise tax equates to less than three cents on a can of beer and less than a penny on a glass of wine.

The National Alcohol Tax Coalition estimates that an increase in federal excise taxes could generate additional revenues of between $4.3 billion and $20.5 billion annually. Currently, $5.4 billion is generated in federal excise taxes, or less than one percent of all federal revenues. In 1951, when beer and wine taxes were last raised, alcohol taxes accounted for approximately five percent of all federal revenues.

Increased alcohol taxes would, of course, be user taxes, and would have no impact whatsoever on the estimated 36 percent of the population that abstains from alcohol use. Also, it would have minimal effect on light and moderate drinkers. The U.S. Department of Health and Human Services estimates that 10 percent of all drinkers account for 50 percent of the alcohol consumed in the United States.

The majority of Americans favor increasing the tax on alcoholic beverages. More than half of the people surveyed in a 1983 Gallup Poll said they favored doubling the federal tax on alcoholic beverages. Many prominent organizations including the American Association of Retired Persons, the National Council on Alcoholism, the American College of Preventive Medicine, and the Center for Science in the Public Interest support the tax increases.

Also, several dozen leading economists, including Stanford's Victor Fuchs and Princeton's Alan Blinder, have petitioned Congress to increase federal excise tax on alcoholic beverages. They "believe that the public health costs and other external costs associated with the consumption of alcoholic beverages are so significant as to justify substantial excise taxes on those beverages."

Alcohol abuse in America costs the nation more than $120 billion annually -- approximately 25 times the amount generated in excise taxes -- and accounts for about 10 percent of the nation's death toll. And alcohol consumption is rising. Per capita consumption rose approximately one-third from 1960 to 1982, with beer and wine leading the way. Advertising expenditures for alcoholic beverages have increased to approximately $1 billion a year, including more than $500 million by the beer industry alone.

Duke University researchers estimate that if alcohol taxes doubled and then equalized, consumption of alcoholic beverages could be expected to drop by approximately 14 percent.

The Americans for Substance Abuse Prevention and Treatment joins with other organizations in urging an increase in beer and wine taxes and earmarking the revenue for:

-- Alcohol research

-- Prevention

-- Treatment

-- And support of health care programs such as Medicare Medicaid and publicly funding agencies such as NIAAA, NIDA and the National Institute on Mental Health.

Thank you for the opportunity to present our views.

Statement of
Association for Advanced Life Underwriting
Presented on
Revenue Increase Options
Committee on Finance
United States Senate
August 17, 1987

The Association for Advanced Life Underwriting (AALU) is a nationwide organization of life insurance agents and others engaged in the use of life insurance and related products in the fields of business continuation planning, estate planning, retirement plans and employee benefits. This statement is submitted on behalf of our members and, more significantly, on behalf of our millions of policyholders who rely upon the protection they receive from billions of dollars of life insurance coverage. We believe we can accurately convey to the Committee the response that can be expected from our policyholders once the full impact of the Joint Committee's options is understood by the country.

We support and adopt the statements of the National Association of Life Underwriters and the American Council of Life Insurance and look specifically to the latter organization for leadership in matters that affect life insurance company taxation.

## A. General Comments.

This statement will set forth AALU's comments on those of the Joint Committee's possible options to increased revenues which will have particular impact on the life insurance industry and the people it serves. We are most concerned with the fact that implementation of one or more of these options is part of a process which, no matter how important in terms of Federal budgetary considerations, is simply ill suited to the implementation of complex, technical tax proposals requiring intense and often lengthy review. Furthermore, the tolerance of the public is, we fear, wearing exceedingly thin for constant and often chaotic changes in our Revenue laws.

### 1. We Are Enmeshed In An Unacceptable Continuum of Detrimentally Repetitive Tax Legislation.

The current proposals appear to be part of an ongoing system of enactments and reenactments of major tax legislation on virtually an annual basis throughout the last half decade or so. Major tax reform legislation has been enacted in 1981, 1982, 1984 and 1986. It appears that 1987 is to be next. Thus, if we do have a major change in the tax code this year, it will constitute the fifth such change in the past seven years.

This sequence of excessive and sometimes contradictory tax legislation cannot help but cause public disrespect for the taxing system and the legislative process which produces that system. Outrage is not too strong a word to use to describe the expected public response to revenue law changes that come at a rate that overwhelms the taxpayer's ability to absorb them. Our government is one of laws and not of men; however, this government of laws is designed for men who, if they cannot understand those laws, cannot be expected effectively to interpret or use them.

It is difficult enough for tax professionals to maintain a semblance of understanding of this continually changing Revenue Code; it is literally impossible for the public to do so. The Revenue Service, itself, falls prey to this problem, being well behind in the promulgation of regulations for Revenue Code sections whose lifetimes often barely exceed infancy. It is simply unreasonable for the Congress to anticipate that the country will be able to conform its conduct to confusing, changing rules before the Revenue Service, the ultimate expert in these matters, can finally decide what it thinks these new rules mean.

This constant process of tax change breeds public confusion and antipathy to the entire legislative process. It also prevents business from planning meaningful and responsible future courses of action. Further, as we have noted, it causes an inability on the part of the Revenue Service to administer the system in an equitable and efficient fashion. We do not overstate the case when we suggest that the Congress is now running the risk of generating an anarchic and total unmanageable public response to our tax legislative process.

### 2. The Budget Reconciliation Process Is An Inappropriate Means Of Effecting Major Changes In Technical Tax Matters.

The budget reconciliation process, as it is now structured, is inconsistent with the development of a rational approach to tax legislation. That process produces unnecessarily rigid time limitations and provides inadequate opportunity for review of technical issues. A substantially longer lead time for that review should be provided. It is clearly inadequate to commence the tax portion of the process early in the summer and to conclude this initial phase of public opportunity for input less than two months later, particularly in light of the recently-enacted 1986 Tax Reform Act and the statements of leading Congressional spokesmen that additional substantive tax reform would not be addressed in 1987.

We are mindful that Federal budgetary matters are of extreme importance and should be addressed promptly by the Congress. However, the budgetary process is a blunt macroeconomic tool designed not only to regulate the Federal governmental process, but also to assist in managing our national economy. It is ill suited to the intricate and often minute analysis which is necessary as a precondition to meaningful tax legislation. This is particularly true of tax system potential changes which are of a relatively minor budgetary impact considering the large dollar numbers with which we are working. It is vastly preferable to make one or two or three major tax system changes (e.g., tax rate changes, new or expanded excise taxes) which on a cumulative basis will attain the dollar goal--in this case apparently $65 billion--than to accumulate a series of smaller changes which by their very nature require significant and time-consuming analyses.

The proposed changes we are addressing in this statement are of the smaller variety in budget number terms and should not be pressured to passage by the budget reconciliation process. If we permit that process to overrun the tax process, we will only feed the public outrage that is being generated by the unacceptable speed of tax legislative change referenced above.

While we would object to many of the proposed options, we will focus in this statement on three general categories which are of particular concern to the life insurance industry--life insurance and annuity policyholder issues, estate and gift issues and retirement benefit issues.

## B. Life Insurance and Annuities.

Among the suggestions appearing primarily on pages 221 through 227 of the Joint Committee Option Paper are the following, all of which would have unacceptable, adverse impact on our private life insurance system:

a. Tax the so-called inside buildup.
b. Include the inside buildup as a preference in the alternative minimum tax base.
c. Tax policy distributions on a LIFO basis.
d. Treat life insurance policy loans as LIFO distributions.
e. Narrow the definition of life insurance, ostensibly for the purpose of excluding allegedly investment heavy products.
f. Apply imputed income rules to life insurance loans on a net basis.
g. Tax annuities in the hands of individuals on the accrual basis applicable to corporations.

Since many of the reasons why the above proposals are inappropriate apply to all of them, we will set forth our discussion as generally applicable to all the proposals. It should be clear from the context of our discussion when we are considering a specific option and when we are proposing analyses which apply to more than one, perhaps in some cases to all, of the options.

We recognize that in recent months attention has been directed to certain marketing techniques involving single premium life insurance. Those techniques, which often utilized overly-aggressive promotional and advertising claims, have raised questions concerning the adequacy of the current tax treatment of single premium policies. That subject will not be treated directly in this paper, partially because it entails a degree of complexity requiring a broader time period than that available for the preparation of this paper, but more importantly because we understand that the issue will be examined, perhaps later this year or early next year, in a detailed review of the effect of recent tax legislative changes as applicable to the life insurance industry.

We acknowledge that the questions raised about single premium life insurance are serious ones which deserve Congressional attention. The answers to those questions, however, should not be pre-judged in a process in which there may not be sufficient time to make the appropriate analyses; otherwise, unnecessary damage to the legitimate uses of single premium and other forms of life insurance could easily result.

## 1. The Current Approach To the Taxation of Life Insurance Policyholders Is Appropriate In Implementation of the Social Policy of Encouraging Death Benefits.

Since the commencement of the application of formal Revenue Code rules to life insurance, the accumulation of life insurance policy cash values has not been subjected to tax. Alternatively, the receipt of dividends by owners of traditional participating policies and of withdrawals by owners of universal life policies (herein such dividends and withdrawals being collectively called distributions) has been taxed to policyholders. However, that tax has been imposed only after recoupment by the recipients of their full basis in the policy. In addition, policy loan proceeds have never been treated for tax purposes as policy distributions subject to tax.

This long-standing series of tax rules reflects a sound legislative judgment which has been reached over and over again as the tax treatment of the life insurance industry and life insurance policies has been reexamined by the Congress. The existing system of life insurance taxation encourages, perhaps more accurately, makes it possible to have, a viable private death benefit structure. The Congress has repeatedly agreed that a life insurance system which, in contrast to other forms of savings, is specifically designed to protect beneficiaries (whether individuals, trusts or business entities) following a death--usually of the family breadwinner--is of sufficient importance to warrant strong encouragement by the taxing system.

## 2. The Current Approach To the Taxation of Life Insurance Policyholders Is Totally Consistent With Generally Applicable Principles of Taxation.

The option which would impose a tax on so-called inside buildup ignores the fact that such a tax would be imposed even though the policyholder had neither actually nor constructively received that buildup. Furthermore, the policyholder would not in any event have access to the inside buildup without incurring a real and burdensome cost.

For example, if he were to receive a distribution from the policy he would be relinquishing the benefit of having the amount of that distribution remain in the policy to support greater future death benefits or lower future costs. In fact, the current method of taxing distributions from life insurance policies is an acknowledgement that such a distribution is an adjustment of death benefit cost to be applied first against policy basis.

Where a distribution results in the direct reduction of policy death benefits, it is patent that such a distribution entails a real cost to the policyholder and is not a form of income return. Where there is no direct reduction in death benefit as the result of a distribution, there will inevitably be increases in future policy premiums either directly, as is typical of universal life policies, or through future dividend adjustments, the approach which is more typical of traditional participating policies.

Thus, in either event a policy distribution involves trade-offs, the presence of which make it inequitable to impose a tax prior to the receipt of that distribution (i.e., on the cash value accumulation) or on the receipt of that distribution until after all basis recovery has been effected.

That inequity is no less present where the tax on the inside buildup takes the form of a so-called preference tax, whether through an alternative minimum tax approach or through a specific impost on a defined class of preferences. The principles that lead to rejection of the options that would impose a direct tax on life insurance policyholders are equally applicable to these indirect forms of taxation.

### 3. Loans Are Not And Should Not Be Treated Like Policy Distributions.

Borrowing against the security of insurance cash values entails, even more so than policy distributions, major costs to the policyholder in that a policy encumbered with a loan has a lower net death benefit. In addition, the policyholder is forced to pay an interest cost, as in the case of any arm's length loan, and must, on or before termination or maturity of the policy, repay that loan and remove the encumbrance.

That interest is nondeductible pursuant to standard personal or investment interest rules. The deductibility of that interest is specially limited in many business situations by an amendment enacted in 1986 to section 264 of the Code which unfairly discriminates against life insurance versus all other business property. That special business deduction disallowance is predicated upon the nontaxability of the inside buildup. Imposing a tax on policy loan proceeds would be inconsistent with the 1986 amendment to section 264 and would constitute a punitive attack on life insurance.

Furthermore, the degree of reliance policyholders have placed on access to policy cash values through loans cannot be overemphasized. Any effort to cut off that access for existing policies would not only be inequitable, but would surely be met with outrage from our policyholders. That response can be expected particularly from older people who traditionally rely on loans against their policies to cover a multiplicity of legitimate needs. Insurance borrowers are burdened with a meaningful interest cost; an unnecessary tax cost should not be added to that burden.

### 4. Congress Has Repeatedly Rejected Changes In Life Insurance Taxation Identical or Similar To Those Proposed In The Option Paper.

Starting in 1983, with the so-called Stark-Moore hearings in the Ways and Means Committee and following through other similar hearings in that Committee and in the Senate Finance Committee, the taxation of life insurance at the company and policy levels has been reexamined by the Congress in almost excruciating repetition and detail. Proposals to tax the inside buildup, policy distributions and policy loans were considered and rejected.

Substantially less than a year has passed since enactment of the 1986 Tax Reform Act and we have not had even one full taxable year of experience under the provisions of that enactment. Some reasonable time to assess the success of that Act is surely warranted. Furthermore, to make any change in the treatment of policy taxation in the short period available with no meaningful opportunity for examination of the substantive issues would be unjustifiable in light of the rejection of any such changes after reexamination of the same areas over the prior four year period.

### 5. The Life Insurance Definition Is Operating As Intended And Should Not Be Changed.

The proposal to change the definition of a life insurance policy is inappropriate for many of the reasons stated above.

Revenue Code section 7702, which sets forth a rather detailed definition of life insurance and which was enacted initially in 1984 as an expansion of the then two year old section 101(f), is the result of a careful process of study culminating in the adoption of specific standards respecting the investment component of a life insurance policy. That section contains intricate rules which measure the permissible premium and cash value accumulations in a policy relative to death benefit. Those standards were enacted specifically to measure the degree to which advance funding is necessary and appropriate in order to guarantee identified levels of whole life death benefits.

There has been no showing that these standards are incorrect. Furthermore, the subject is of such complexity that it would be impossible to engage in a review of those standards within the time frame mandated by the budget reconciliation process.

### 6. Corporate Annuity Taxation Principles Should Not Be Extended To Individually Owned Annuities.

The Congress was not well advised when last year it extended an accrual basis form of taxation to corporate owned annuities. It should not compound that error by now applying that approach to individually owned annuities.

The retirement benefit function of the annuity policy, whether held directly by an individual or serving as the funding medium for a corporately paid retirement benefit, is undermined by the imposition of the tax prior to the receipt of benefits under the policy.

### C. Estate Tax Imposition on Life Insurance.

The Joint Committee Option Paper proposes a sequence of options by which revenues could presumably be extracted from the estate and gift tax system. We can appreciate that in a revenue driven reexamination one might consider the efficacy of generally applicable changes, such as rate changes and basis step-up amendments. We are, however, at a loss to understand the equity of a change which proposes that life insurance--in contrast to all other forms of property--may not be passed on to family members at death free of an estate tax. That is precisely what the option paper suggests when it proposes on page 261 that a life insurance policy payable to a relative of the insured will be included in the insured's gross estate irrespective of the insured's incidents of ownership to that policy.

Such a proposal is plainly discriminatory to life insurance policies. For example, an individual can buy a share of stock on margin, transfer that share to his child subject to the margin account and continue periodically to pay amounts that will be applied against the margin account. The payments of the periodic installments of the purchase price would constitute gift transfers subject to the imposition of gift tax if warranted under general gift tax rules. However, at the time of death the then value of the share of stock would not be included in the decedent's estate. This is analogous to what happens currently with respect to life insurance. If the insured transfers the policy by gift, the gift tax rules apply at the time of each premium payment. The transfer tax system, having extracted such tax as may be due during life, does not impose a tax at death.

The reasons given in the Joint Committee pamphlet in support of this option of increasing the estate tax on life insurance fall far short of a satisfactory explanation for the proposal. The pamphlet states that,

> "an individual may take out a life insurance policy, irrevocably designate beneficiaries of the policy, and transfer all incidents of

> ownership to another person. In that situation, the proceeds of the life insurance policy are not includible in the decedent's gross estate even if the decedent pays all policy premiums. Such an arrangement effectively transfers the property at death while avoiding estate tax." (Emphasis supplied.)

Let us suggest the redrafting of that quote, substituting a share of stock for life insurance policy.

> "An individual may purchase a share of stock, irrevocably designate new beneficial owners of that stock, and transfer all incidents of ownership to another person. In that situation the value of the share of stock is not includible in the decedent's gross estate, even if decedent pays the entire purchase price of the share. Such an arrangement effectively transfers property at death while avoiding estate tax." (Emphasis supplied.)

Clearly life insurance should not be treated differently from the share of stock for estate tax purposes.

The second reason given in the Joint Committee pamphlet is that, "life insurance is inherently a death time transfer. Adoption of the proposal would ensure that all transfers at death are subject to estate tax."

Life insurance is inherently a death time transfer if it is owned at the time of death. If it is cashed in prior to death, it is no more inherently a death time transfer than any other property. Furthermore, at the time of such cashing in income tax would be paid to the extent that the cash value exceeds basis. Likewise the ownership of a share of stock is inherently a death time transfer if that share of stock is owned at death. Adoption of this proposal for shares of stock would ensure that all transfers at death of such shares of stock are subject to estate tax.

The drafters of this option may feel that life insurance is not now appropriately taxed under the estate tax system as compared to other forms of property. However, they simply have not provided a satisfactory reason to support that feeling. Furthermore, they have not taken into account that, unlike many other forms of property, a life insurance policy (or premium in connection therewith) which is transferred within three years of death, does not escape inclusion, in whole or in part, in the gross estate. The option paper's insinuation that life insurance currently is for the most part beyond the scope of the estate tax system is simply unwarranted.

This seeming animus towards life insurance is also reflected in the limitations proposed on page 269 of the Option Paper to utilization of gift tax present interest generating Crummey powers by permitting validation of only so-called "hanging" Crummey powers. This proposal, if adopted, virtually guarantees additional limitations on the use of life insurance trusts. It is very difficult, if not impossible for a trustee to commit monies to a continuing investment in a life insurance policy where he will be subject, year after year, to Crummey power invasion and termination of the policy.

Investment in a life insurance policy requires reasonable assurances of permanency and continuity. Those assurances will not be possible if the Congress mandates that the Crummey power must be present indefinitely. This proposal, in common with the option directly respecting the estate tax treatment of life insurance policies, should be rejected.

Lastly, we strongly challenge the wisdom and the public policy support for proposals which would tend to deprive small businesses and family farms of the major source of the liquidity necessary to ensure family ownership continuity. There is something intrinsically wrong with proposals that have such an effect.

## D. Pension and Employee Benefit Provisions.

In recent years Congress has raised substantial revenue from pensions and employee benefits--particularly tempting targets because of the substantial assets held for the retirement security of employees and other taxpayers. We urge Congress to avoid the tendency to raise further revenue from this "easy target." Valuable protections would be lost and the retirement security of millions of Americans would be jeopardized.

Considerable sentiment was exhibited in Congress at the time of the passage of the Tax Reform Act of 1986 for avoiding further changes in pensions and employee benefits. Many Congressmen voiced concern that Congress was too frequently amending the rules and causing disruptions in long-term planning. This sentiment was reflected in provisions that delayed for several years the need to make plan amendments. Again, Congress is facing revenue concerns and may be seduced to make changes that will disrupt long-term planning. It should, however, resist that temptation and avoid further changes so that the area can stabilize and employers can once again develop long-term plans. In fact, we would urge Congress to put aside any pension changes pending the development of a rational, fair, efficient and badly needed national pension policy by which we can equitably ensure our taxpayers a satisfactory degree of retirement security.

Five of the pension/employee benefit proposals in the Joint Committee staff options require special comment.

1. Five Percent Excise Tax on Net Investment Income.

One of the proposals would impose a five percent excise tax on the net investment income of all tax-exempt organizations, including section 401(a) qualified pension or profit sharing plans. Clearly the proposal will raise revenue. However, it will do so by directly diminishing the assets available for employees' retirement. This contradicts our established national goal of providing retirement income security through pension and profit sharing plans.

Further, it seems highly unlikely that employers would offset this new tax through increased contributions. Employers generally establish their rates of contribution with respect to how much they can effort to put into the plan and it would be unreasonable to assume an increased contribution from employers to offset this tax. To the extent that employers do increase their contribution, however, there would be, through increased contribution deductions, a reduction in the revenue gains to be achieved from the proposal.

In addition, employees provide for their retirements through three sources: (1) personal savings; (2) pension and profit sharing plans and (3) social security. None of the revenue options is designed to or would enhance personal savings. In fact, the options are designed to raise revenues and reduce personal savings. Consequently, since the funds available through the pension and profit sharing plans would be reduced, either the individuals will suffer lower income in retirement or social security will be inevitably forced to pick up the burden of replacing these lost funds. Enacting an excise tax that eventually leads to increased funding for social security appears inadvisable.

Finally, imposing this excise tax on plans would increase already substantial administrative and filing burdens which should, if anything, be reduced.

2. Repeal of Exclusion for Group Term Life Insurance.

The staff options include two proposals dealing with the income tax exclusion for the first $50,000 of group term life insurance coverage. The first proposal suggests a repeal of the exclusion for all employees, and the second proposal suggests that only high-income individuals would lose the income tax exclusion.

The exclusion from income (and social security wages) of the first $50,000 of group term life insurance provided by an employer has been a mainstay of the tax law for many years. The exclusion has not been increased with inflation and has in fact diminished greatly (in terms of purchasing value). Further, explicit nondiscrimination rules, similar to those required for qualified plans, are imposed so that a group term life insurance plan must provide coverage to both low and moderate income employees. Repeal of the income tax exclusion would doubtless result in a substantial decline in the amount of group term life insurance provided to those employees.

In many cases, the only life insurance protection maintained for an employee is through the group term life insurance plan of the employer. Provision of life insurance protection to employees is a worthwhile social goal that is well justified by the revenue required to maintain this incentive.

### 3. Taxation of Qualified Plan Loans.

One of the proposals would treat all loans from qualified plans as taxable distributions (to the extent that any distribution would be taxable). Since this proposed change does not, according to the estimates, gain much revenue, its inclusion must be justified primarily on policy grounds. Those grounds, the Joint Committee staff suggests, are that it may enhance retirement savings to make all plan loans taxable and that it is appropriate to treat plan loans in the same way that loans from individual retirement accounts are treated.

Neither of these propositions is correct.

Taxation of plan loans would, as a practical matter, mean that plans would no longer make loans to participants. As a result, any revenue gain from this proposal is unlikely.

Taxing or preventing loans to an employee from a plan (loans from other sources, such as a bank, are not taxable) is discriminatory since retirement savings may be the principal financial asset of a lower income employee. Since these retirement savings cannot be assigned as security for a loan from a third party, the only potential source of borrowing for that individual may be the plan itself. In contrast, a higher income employee will likely be able to borrow elsewhere.

The Joint Committee staff suggests that qualified plan loans will reduce the income available to an employee at retirement. This statement is wrong on two counts. First, it overlooks the explicit provisions of current law, which require that loans be repaid within five years (except for home loans). Therefore the funds will be repaid and will be available to the individual at retirement. Second, loans enhance the attractiveness of qualified plans for employees. This elimination will further reduce the incentive to provide retirement plans.

Finally, comparison with an IRA appears unjustified. IRAs are maintained by an individual for himself. Qualified plans are maintained by third-party administrators for employees generally. As such, the third-party administrators are ensuring that the plan complies with all repayment requirements. Substantial differences between IRAs and qualified retirement plans justify a difference in the tax treatment of loans.

4. Reduction in Full Funding Limitation.

Under current law, employers make deductible contributions within limits to fund defined benefit retirement plans. One of those limitations is referred to as the full funding limitation, i.e., the amount of assets necessary to fully fund the plan based on the projected benefits that will be provided by it. Projected benefits are used because pension plans are ongoing plans. In fact, the plans are required to be "permanent" as a necessary condition of their qualified status.

One of the staff proposals is that the full funding limitation be reduced by recalculating the limitation based on a plan's termination liability, rather than its projected benefits. The assumption is that the plan is likely to be terminated in the near future and that a lower amount of assets will be required to meet the full funding limitation.

This proposal should be rejected because it undermines one of the important mainstays of defined benefit pension plans. The Administration and members of Congress have offered many legislative proposals designed to improve the funding of defined benefit plans to ensure that adequate benefits will be available to employees on retirement. The proposal to restrict the full funding limitation is contrary to that goal.

The short-term tax needs for revenue should not undermine the retirement security of employees. This option would, unfortunately, do just that.

## Association of American Vintners
## and
## Wine Institute

### Summary of Opposition to Wine Excise Tax Increases
### Committee on Finance
### United States Senate
### July 16, 1987

1. Even at the present tax level of $.17 per gallon, from 1984 to 1986, the consumption of table wine — the wine most consumed in America — has dropped 50 million gallons, from 401.3 million to 350.6 million gallons. U.S. produced table wine has declined 6%, from 283 million to 267 million gallons. The overall decline in U.S. produced table wine sales can be traced to the fall off in the large, popularly priced "jug" wine market, which has decreased an estimated 10 million gallons a year.

   Wine cooler sales which have increased from 34.2 million to 120.4 million gallons in the last 3 years, have obscured the plight of American vintners and growers. If the non-wine portion of wine coolers is factored out, total per capita wine consumption in America has declined from 2.27 gallons in 1984, to 2.25 gallons in 1985, to 2.18 gallons in 1986.

2. Regressive wine and beer tax proposals that call for a change in the traditional method, based on a specific tax per gallon, to revolutionary and unprecedented new formulas tied to alcohol content and "proof gallon," if enacted, will produce a shattering blow to the wine economy and invalidate all tax projections and revenue estimates.

   For example, one of the Joint Committee on Taxation draft options to raise wine and beer taxes to the "proof gallon" equivalent of spirits would result in a 1,665% tax rate increase from $.17 per gallon to $3.00 per gallon, for 12% table wine, the most representative American wine. For a typical $3.00 bottle of wine, using wholesale and retail markups of 25% and 50%, the price would increase about $1.10 per 750 ml bottle, and about $2.20 per 1.5 ml bottle. For a $7 jug wine of 4 liters, using the same markups, such a tax would add another $6.00 to the price of wine. While other revenue options are less extreme they are still crippling; and one which calls for a 3,330% increase would be tantamount to confiscation.

3. These huge tax increases on table wine would fall especially hard on lower and middle income consumers. About 60% of all American wine (excluding coolers) is sold as jug wine in bottles of 1.5 liters or larger. Approximately 80% of all American table wines are sold at $3.00 or less per 750 ml ($18.00 or less per case f.o.b.). Reliable surveys report that 74% of wine is consumed in the home; and 66% is consumed with food, verifying the knowledge that wine is essentially a mealtime beverage for most wine households. Many of these consumers, according to a recent study by Peat, Marwick Main & Co., commissioned by the Coalition Against Regressive Taxation, would pay more in increased excise taxes than what they would save in income taxes as a result of last year's Tax Reform Act.

4. In 1985, federal excise taxes on all wines, American and foreign, generated $274.5 million. In 1986, with falling sales in several categories, that revenue fell to $270.3 million. Champagne and sparkling wine constituted 55% of that total, declining from $159.8 million in 1984 to $157.1 million in 1985 to $150.3 million in 1986. The champagne tax at $3.40 a gallon, converts to $14.17 per proof gallon (for 12% alcohol by volume), making it higher than spirits which is taxed at $12.50 per proof gallon. Yet, tax

writing staffs are contemplating formulas and rates, that on paper could generate as much as $1 billion more in FY 1988, and $3 billion more over the next three fiscal years. The unreality of squeezing such money out of a faltering industry and hard pressed consumers should be readily apparent and immediately dropped.

5. While the timing of increased taxes is never good, this period is an especially vulnerable one for the American wine industry which is still in its infancy. In addition to the major producing regions, wine grapes are being grown and new wineries are emerging in 34 states. This fledgling development has received positive consumer support, has offered the prospect of new agricultural alternatives, and has assisted local tourism and hospitality ventures. Federal wine excise tax increases would be contrary to recent state farm bills designed to encourage local wine and winegrape development.

   This infant industry faces the special burden of vineyard farming whose characteristic is that it takes four years to produce a commercial crop and eight years for the vineyard to reach full production. Vineyards generally do not show a positive cash flow before their fifth year; wineries often not until their tenth year. (30% of American wineries are less than 6 years old). A large federal excise tax increase could be the single strongest element that snuffs out any ability for infant wine state economies to survive.

6. Given the dramatically regressive nature of the "proof gallon" formulas, estimates of a precipitous 30% loss in sales volumes must be viewed as credible. The popularly priced, and already troubled, "jug" wine category could plummet even further. The loss of wine sales will result in an oversupply of grapes, and depress prices for the entire grape-growing community, which includes growers of raisin, table, and juice grapes.

   A conservative analysis of a 30% drop in American wine sales would cause a 135 million gallon loss, worth about $810 million f.o.b., or $1.5 billion retail. The resulting decrease of 870,000 tons of grapes would force the economic abandonment of over 100,000 acres or 800 vineyards, and an estimated 51,000 jobs. Thus, projected federal revenue gains must be recalculated and put in the context of offsetting losses in income taxes. At the state level, where 47 states tax table wine higher than the $.17 per gallon federal excise rate, we can expect a loss of over $50 million in state excise taxes and license fees. Most observers are unaware that the federal excise tax is in addition to state excise taxes, state income taxes, property taxes and, in many instances, sales taxes which generate hundreds of millions of dollars and which make our consumers among the most taxed citizens in America.

7. Separate and apart from the analysis of future losses, triggered by massive new excise increases, many winegrape growers face bankruptcy right now. The price of grapes in many areas is at a level that is well below the farmers' cost of production. The value of San Joaquin vineyards, where most California winegrapes are grown, has declined from 50% to as much as 80% between 1982 and 1986. In 1986, 79,000 acres of California vineyards were either abandoned or not harvested.

   Across the country, vineyard conditions are truly stark. Though American wines receive world class recognition, they are impacted negatively by such factors as international subsidies and governmental restrictions. About 1,000 of the 1,200 wineries in America are small businesses primarily owned and operated by families, who raise their own grapes and make their own wine. These families produce less than 15,000 gallons a year. About 80% are losing money; 86% of their grape growing partners are losing money. All this prevails at existing wine excise tax rates.

8. Our competitive position with foreign wineries and winegrape growers can be further eroded. Mainly as a result of foreign governmental subsidies and currency fluctuations, foreign wines until 1986, enjoyed an uninterrupted decade of market expansion, especially in the lower price ranges. In 1975, their share of the table wine market was 17%. In 1985, that share had grown to 30%. In 1986, the combination of European wine scandals, which underscored America's high quality health standards, and a more realistic dollar, caused a shift to 24%. But the American balance of trade deficit for all wine categories deteriorated further as foreign wine values rose $20 million from $1.01 billion in 1985 to $1.03 billion in 1986.

   While an increase in the federal excise tax on wine applies to both American and foreign wine in the U.S. market, we can anticipate that many foreign governments will absorb any excise tax increase through additional subsidies. This would make the impact much more severe on the American producer. (Overall, the value of the various subsidies is estimated at 29% of the value of French wine, 19% of Italian wine, and 17% of West German wine). Moreover, on the other side of the trade ledger, the American wine industry continues to be seriously impeded by discriminatory tariff and non-tariff trade barriers in its export drive to open overseas markets.

9. A significant flaw in the "proof gallon" approach concerns champagne and sparkling wine which possess the same alcohol content as table wine. Champagne and sparkling wine is presently taxed at $3.40 per gallon, which on a "proof gallon" basis is higher than spirits. If the revenue options to increase the wine tax to $12.50 a proof gallon were enacted the tax on champagne at 12% would be reduced from $3.40 to $3.00 a gallon, while the tax on 12% table wine would rise dramatically from $.17 to $3.00 a gallon. This inequity results from the attempt to impose artificial formulas and mathematical equations on divergent products.

10. The "proof gallon" approach could create new administrative costs. The present simple excise tax rates of $.17 a gallon for still wine with an alcohol content not over 14% and $.67 a gallon for a still wine over 14% and less than 21%, would be replaced by a complex formula for every single percentage. (See attached chart.) BATF most likely would have to add additional personnel to administer the new taxing code which could also trigger new regulatory burdens regarding wine production percentage variances and labeling requirements.

**ASSOCIATED TOBACCO MANUFACTURERS**
**Post Office Box 126**
**King of Prussia, Pennsylvania 19406**

August 10, 1987

Honorable Lloyd Bentsen
Senate Finance Committee
Suite 703, Hart Building
Washington, DC 20510

Dear Mr. Chairman:

Associated Tobacco Manufacturers represents six companies that manufacture tobacco products other than cigarettes. Our member firms, their employees, families and the consumers who buy their products are opposed to excise taxes as a method of raising revenue. The purpose of this letter is to go on record to that effect.

First, this hidden tax is regressive with its adverse impact disproportionately affecting lower income consumers. It also burdens only a segment of the population base. The effect of such a tax would be to lower the consumption of products made by our member firms. This not only puts in jeopardy the jobs of the employees of our members, but will also reduce the yield anticipated by such a tax. While some legislators may approve of a drop in the consumption of tobacco products, behavior modification should not be a consideration as the options for revenue raising are debated.

More specifically as to the products of our members:

Smoking Tobacco - In the past 10 years consumption of smoking tobacco has declined 56.9%. It has been off every year since 1984 by more than 10% per year and right now is running at 20.4% behind last year's first quarter results. When the federal excise tax on smoking tobacco was repealed in 1966, the tax was 10¢ a pound. If that tax rate were to be reinstated, the revenue derived would be $2 million dollars a year. Even at the extraordinary rate of 48¢ per pound, an option of the House Ways & Means Committee, the revenue would be less than $10 million.

Smokeless Tobacco - On July 1st of last year an excise tax on this product was reinstated at the rate of 8¢ a pound on chewing and 24¢ a pound on snuff. It seems hardly fair to increase the excise tax on smokeless tobacco just over a year after its reimposition, especially when the revenues derived would be insignificant.

Cigars - Cigars have been on the decline for many years. Last year's consumption was only 60% of what it was 10 years ago. Cigars are highly price sensitive. An increase in the excise tax would deal a major blow.

In view of the fact that the aforementioned products do not raise significant revenues, Associated Tobacco Manufacturers urges the committee not to consider excise taxes on these products in their effort to reduce the deficit.

Very truly yours,

Herbert H. Middleton
President

HHM/ph

## TESTIMONY SUBMITTED BY

JAMES C. SANDERS

PRESIDENT, THE BEER INSTITUTE*

## EXCISE TAXES -- AN UNWISE WAY TO REDUCE THE FEDERAL DEFICIT

During the 1986 debate over tax reform, the Senate Finance Committee gave serious consideration to a de facto 54% increase in federal excise taxes. After extensive hearings on the unfairness, regressivity and inefficiency of excise taxes, the Finance Committee abandoned that approach in favor of more equitable tax policies.

Now, one year later, excise taxes are again receiving serious consideration as a means of meeting all or part of anticipated revenue needs.

However, since excise taxes are based on consumption patterns rather than on the taxpayer's ability to pay, they are no more acceptable today than in 1986. For it is wrong to think that excise taxes are levied on individual industries or specific products. They are levied on people -- predominantly on middle- and low-income consumers who devote a greater portion of their income to the taxed items. As such, excise taxes are highly regressive.

Earlier this year, the Congressional Budget Office studied the distributional impact of higher excise taxes on beer, wine, liquor, tobacco, gasoline, air fare and telephone service. It found that the impact of an increase in such taxes would be:

> "... noticeably regressive. The average increase in taxes as a percentage of total income would be about twice as large (more than three times as large in the case of the tax on beer or tobacco) for families with incomes between $10,000 and $20,000 compared to families with incomes of $50,000 or more" (Congressional Budget Office, The Distributional Effects of an Increase in Selected Federal Excise Taxes, January, 1987).

## INCREASED RELIANCE ON EXCISE TAXES WILL ELIMINATE TAX REFORM FOR MOST AMERICANS

In fact, reliance on higher excise taxes is little more than a form of reverse Robin Hood-ism, taking the benefits of tax reform away from middle- and low-income groups, while preserving them for the wealthy.

It has been estimated that an $18 billion increase in federal excise taxes would constitute an approximately $285 across-the-board tax hike for all American households (Quick, Finan & Associates, Federal Excise Taxes: Cost to the Average American Household, July, 1987). Such a regressive tax increase will effectively eliminate the benefits of last year's tax reform law for any household that realized less than that amount in reduced tax payments.

And that includes most middle- and lower-income Americans. As noted in a study released earlier this year:

> "... the excise tax increase for low income taxpayers greatly exceeds the tax reduction these same taxpayers received from the

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*The Beer Institute represents 35 United States brewers and 65 associate members. A list of members is appended to this testimony.

> Tax Reform Act of 1986. For families with incomes of less than $10,000, the excise tax increase is nearly 5 times as great as the income tax reduction. In direct contrast, for taxpayers with incomes in excess of $100,000, the excise tax increase is only 6 percent of the enacted income tax reduction" (Peat, Marwick Main & Co., An Analysis of the Regressivity of Excise Taxes, May, 1987).

Throughout the debate over tax reform, Congress emphasized "leveling the playing field" ... building a tax system that treats citizens fairly, based on their ability to pay. But "preserving" tax reform by raising excise taxes is an illusion that would, in many respects, represent the antithesis of reform.

The 99th Congress worked hard to make the tax system more equitable for all Americans. It is to be hoped that the gains made will survive efforts by the 100th Congress to meet deficit reduction targets.

## BEER TAXES -- A REGRESSIVE AND INEFFICIENT WAY TO GENERATE ADDITIONAL REVENUE

All excise taxes are regressive ... but few are as regressive as the excise tax on beer.

The Congressional Budget Office study compiled earlier this year identified beer taxes as one of the two most regressive forms of excise tax. That is because beer consumers are overwhelmingly working men and women, with two-thirds of American beer sales accounted for by families with annual incomes of $30,000 or less.

Looked at another way, households with incomes in the $20,000 to $25,000 range spend more than 50% of their alcohol beverage budget on beer. Conversely, those with family incomes of more than $50,000 spend only about 25% of their alcohol beverage budgets on beer (Bureau of Labor Statistics, Consumer Expenditure Survey, 1980-81). Since beer is most popular among American working men and women, tax policies that raise the price of beer are highly regressive and place an unfair burden on people who are already paying their fair share.

In fact, raising the excise taxes on beer is one of the most regressive Staff Options presented to the Committee. It is also one of the most inefficient, since it would end up costing consumers from $2 to $3 at the cash register for every dollar in added tax revenue realized by the government.

This extreme inefficiency results from the fact that federal excise taxes are levied at the brewer level, and thus become an intrinsic part of the wholesale and retail price of beer. Any additional tax levied on the brewer will be subject to normal markup as the product moves toward the marketplace. By the time it reaches the consumer, it will have been marked up twice -- and typically will be more than twice as large as it was at the brewer level. As a result, the total consumer cost of any federal excise tax increase is more than double the amount of revenue collected by the government.

And beer consumers are already paying a disproportionately high tax rate. Every time one of America's 80 million beer drinkers buys a six-pack, he or she pays about three times more tax than when purchasing other goods which have no excise taxes. Beer drinkers pay $1.6 billion a year in federal excise taxes, plus $1.3 billion annually in state excise taxes and license fees, plus another $1.5 billion in state and local sales taxes.

In fact, the price of beer includes more for taxes than for all agricultural raw materials (including the hops, barley and grains) plus the total payroll of the brewers who produced it -- combined.

To put the current tax burden on beer into full perspective, it should also be remembered that in the past 35 years federal excise taxes have been completely removed from such items as stock transactions, furs, jewelry, perfume, silver bullion and slot machines. During that same period, federal and state excise tax collections on beer have grown by almost 600 percent. Given these facts, one must wonder why excise taxes are sometimes described as "luxury" taxes.

## EXCISE TAXES ON BEER SHOULD NOT BE RAISED TO RECOUP "EXTERNAL SOCIAL COSTS"

Some observers have maintained the federal excise tax on beer should be raised to recover the "social cost" of alcoholism and alcohol abuse. While the brewing industry agrees that these problems are important societal issues, they cannot be used as a legitimate justification for higher taxes:

- O Many consumer goods carry "social costs," but are not subjected to discriminatory taxation. Coffee, candy, soft drinks, fast foods, eggs, autos and even prescription drugs can cause problems if misused or abused. But no one has urged that they be taxed.
- O Moderate consumption of alcohol has been shown by scientific research to provide health benefits ... a fact totally ignored by the "external social cost" theory. To site just one example, a 10-year study by the Kaiser-Permanente Health Plan found that moderate drinkers have a lower death rate than either heavy drinkers or abstainers. Thus, even abstinence can be said to create a "social cost."
- O Manipulating the tax code to increase the price of alcohol beverages will penalize the responsible drinker but leave the abusive drinker's behavior unchanged. Higher taxes may cause abusive drinkers to switch to cheaper products, but will not solve abuse. That is why Stanton Peele, of Organization Health Systems, recently wrote that:

> "The evidence is ... that control of supply policies will never reduce substance abuse significantly and that such policies may backfire by propagating images of substances as being inherently overpowering." ("The Limitation of Control-of-Supply Models for Explaining and Preventing Alcoholism an Drug Addiction," Journal of Studies on Alcohol, Vol. 48, No. 1, 1987).

Increases in the excise tax on beer cannot be justified on the theory that alcohol abusers -- or their families -- will somehow be helped by increasing the cost of beer, wine or liquor.

## THE EXCISE TAX RATE ON BEER SHOULD NOT BE "EQUALIZED" WITH THAT OF LIQUOR

The proposal to "equalize" the federal excise tax rate on beer with that of liquor amounts to nothing more than a 300% tax increase on the 80 million working Americans who drink beer. It would do nothing to make the tax code more "equal".

In fact, such an increase is so drastic that it would completely disrupt existing consumption patterns, raising the federal taxes paid by beer drinkers from the current level of $1.6 billion to approximately $6 billion a year. This would encourage consumers to shift from beer to hard liquor, the most concentrated form of alcoholic beverage.

Creating a tax structure that makes a bottle of other types of higher alcohol content beverages less expensive than a 6-pack of beer is very troubling from a public policy perspective. And there is also solid evidence that causing consumers to switch from a domestic product -- beer -- to other alcohol beverages, many of which are imported, will have a significant impact on our nation's trade balance. About 2% of the nation's current trade deficit is due to the importation of foreign wines and liquors ... and "equalization" will just worsen this situation.

Ultimately, policy makers should be concerned about who is being taxed -- not what is being taxed. Beer is purchased primarily by moderate-income wage earners, while a higher proportion of other alcoholic beverages are purchased by higher income groups. Raising beer taxes relative to spirits would simply make the tax system more regressive. Where is the "equality" in a 300% tax increase on "Joe Six-Pak" ... While the higher alcohol content product is left untouched? In very real terms, that would be the effect of "alcohol equalization."

## HIGHER BEER TAXES WILL HURT THE BREWING INDUSTRY

In addition to unfairly singling out 80 million beer drinkers, the Staff Options to increase beer taxes would damage an overwhelmingly American industry:

0 Approximately 95% of all beer consumed in this country is produced by U.S. brewers who generate about 200,000 jobs in beer production, distribution and support industries (Weinberg & Associates, 1985). During the current decade, beer sales have at best grown at a very slow rate. Any excise tax increase large enough to help reduce the federal deficit would inevitably drive down sales and throw thousands of industry employees out of work.

## CONCLUSION

The Committee on Finance is faced with difficult deliberations in the weeks ahead. The members of the Beer Institute supported the Committee's efforts last year regarding Tax Reform.

And likewise this year, if higher taxes are needed, America's beer drinkers and America's brewers are prepared to do their part. Not as a separate group, singled out for discriminatory treatment. But rather, as a part of the total fabric of American society ... subject to the same fair and equitable treatment as all other citizens and corporations.

We fully support the spirit of Tax Reform ... of the fundamental principles which Tax Reform embodies. And we urge that these principles be carried forward in the Committee's decision-making on new taxes.

# STATEMENT
# OF THE
# BLUE CROSS AND BLUE SHIELD ASSOCIATION

The Blue Cross and Blue Shield Association is pleased to submit the following statement on behalf of the Association and its 77 member Plans to the Senate Committee on Finance to be included in the official record of hearings on possible 1987 revenue options.

Blue Cross and Blue Shield Plans provide protection against the high cost of medical care to nearly 80 million Americans. Plans operate in each state and are locally-controlled non-profit health care service organizations. For the fifty years preceeding the Tax Reform Act (TRA) of 1986 these Plans were exempt from federal tax under the provisions of Section 501(c)(4) of the Internal Revenue Code. Section 1012 of the TRA provided that Plans would become taxable as of January 1, 1987, but would have the benefit of certain tax provisions as detailed in the statute. The rules applicable to Blue Cross and Blue Shield Plans were established on the basis that Plans perform valuable community services that should be preserved.

Repeal of the treatment afforded Blue Cross and Blue Shield Plans involving the way additions to reserves are taxed is one of several items recently discussed in a document prepared by the Joint Committee on Taxation listing options to raise revenue. While we understand that hundreds of options are being considered and that the Committee faces many difficult choices in developing an equitable package of revenue decisions, we would urge the Committee not to change the tax treatment of Blue Cross and Blue Shield Plans.

## Blue Cross and Blue Shield Plan Practices

Blue Cross and Blue Shield Plans have a strong obligation to their communities, as well as their subscribers, and discharge those obligations in ways that benefit those they serve. The business practices of Plans clearly demonstrate the corporate philosophy embodied in these organizations.

Plans return a higher percentage of premium payments to subscribers in the form of benefits than do our competitors. The most vulnerable purchaser in the health insurance market is the individual who must purchase coverage for themselves and his/her family without the benefit of being part of an organized group. Plans perform a major community service for these consumers by returning, on average, 89 cents of every dollar collected in individual premiums as payment for health care services. By way of comparison, commercial companies return only 54 cents on the dollar in benefit payments. With respect to Medicare supplemental coverage, Plans pay out 90 percent, on average, of all premium dollars collected, dramatically exceeding the federally mandated minimum of only 60 percent.

All Blue Cross and Blue Shield Plans offer individual coverage. Eleven million of our nearly 80 million subscribers are individuals who do not belong to groups and who represent, by definition, much higher risks than group members. It is precisely because of the higher risks involved in covering individuals that in recent years has caused a number of major insurance companies to simply stop offering individual coverage. This segment of the market is extremely volatile and suffers from a high degree of adverse selection, the phenomenum that occurs when only those who have a need for health care services choose to purchase coverage rather than a mix of healthy and sick individuals.

In addition to the fact that many commercial insurers are reducing their stake in the individual market, it is important to note that newer forms of health coverage such as health maintenance organizations (HMOs) and preferred provider organizations (PPOs) often offer very little individual coverage, and that the rapidly growing number of employer self-funded health benefit programs are not in the business of offering individual (nongroup) coverage.

Blue Cross and Blue Shield Plans guarantee individuals who leave a group for any reason -- and their family members -- the right to convert to individual coverage without waiting periods and without exclusions for pre-existing medical conditions. This benefit helps protect laid-off workers and their families from major financial losses. Importantly, the right to automatic conversion applies to divorced spouses, widows, widowers and families of covered members. Congress recognized the value of such a benefit when under COBRA it mandated that employers allow terminated workers to continue in their group benefits, and many states have required commercial insurers to offer coversion benefits. Blue Cross and Blue Shield conversion benefits will continue to be available even as the continuation coverage offered by employers expires. Blue Cross and Blue Shield Plans have always offered this guarantee voluntarily despite the fact that most Plans lose money on conversion policies because of the extremely high benefit payouts, about 97 cents of every dollar, in these policies.

Plans do not base the price of individual coverage on a person's medical condition. This is of significant value for those who -- because of a pre-existing medical problem -- could not obtain affordable health care coverage from another company.

Even in today's highly competitive market, our practices with respect to individual coverage remain substantially more liberal than commercial insurers. For example, Plans representing over one half of our subscribers offer coverage regardless of medical condition. In those Plans, subscribers continue to be accepted regardless of their medical history. This means that these Plans cover individuals such as those diagnosed with AIDS whom they know, in advance, will incur inordinately high medical expenses. Further, all Plans accept subscribers regardless of their income. A common practice in the commercial industry is to require that all applicants be employed.

Blue Cross and Blue Shield Plans continue to provide small group coverage that many commercial insurers have concluded is an undesirable high cost/high risk business that they will no longer provide. Plans have always remained in the small group market despite economic downturns that have caused other companies to leave this market, perhaps to return in better times. Further, nearly all Blue Cross and Blue Shield Plans offer group coverage to small businesses with as few as ten employees with no restrictions because of medical problems. Our commitment to the small group market is strong and we continue to seek ways to make it possible for more small businesses to offer coverage to their employees.

The bottom line of all these practices is that Blue Cross and Blue Shield Plans accept individuals and small groups who are not accepted by or who could not afford quality coverage from any other provider of health care protection, and they provide that coverage in good times and bad. As an inevitable result, Plans end up with a disproportionate share of high risk, high cost subscribers.

That we can survive at all in the highly competitive health insurance marketplace while covering so many high risks is a tribute to a very delicate balance developed over 50 years of operation. Our aggressive pursuit of cost containment is one key to the Plans' ability to compete while carrying the costs of high risk subscribers. We negotiate rates with doctors, hospitals and other providers to establish the lowest possible costs for our subscribers. Until last year, the exemption from federal taxation was a major part of that delicate balance between income and expenses.

## Tax Reform Act of 1986

When Congress reviewed the tax status of many non-profit organizations as part of last year's major overhaul of the federal tax code, Blue Cross and Blue Shield Plan practices were studied extensively. Congress was persuaded that some competitive advantage might exist for tax-exempt Plans in today's market where they compete with commercial for-profit companies, but determined that some recognition should be given for the valuable, community-based practices of Blue Cross and Blue Shield Plans. The provisions of Section 1012 of the Tax Reform Act of 1986 were the resulting compromise.

The tax treatment of reserves of Blue Cross and Blue Shield Plans is the cornerstone of the agreement reached in the tax reform debate. This special deduction provides tax relief, but applies only when Plan reserve levels fall below that which is considered adequate to protect against unexpected events, generally an amount sufficient to pay claims for three months. Any additions to reserves that exceed the three month level will be taxed at the regular corporate income tax rate. It is important to note that Plans under the three month reserve level are subject to the alternative minimum tax. Therefore, while the tax liability faced by a Plan can be reduced by this special provision, it cannot be eliminated.

A key element of the reserve treatment was the decision by the Congress to make the special treatment contingent on each Plan continuing to provide the same level of community services they provided on August 16, 1986. Any Plan that makes a "material change in operations" loses the ability to rebuild reserves to a fully stable level before it must begin to pay regular corporate income tax. This means that the availability of small group and individual coverage, and the special programs such as continuation of coverage through conversion privileges will continue to be available in each community. Congress, in effect, created an incentive to preserve the valuable practices of Blue Cross and Blue Shield Plans in the midst of an increasingly competitive marketplace.

## 1987 Revenue Options

The provision agreed to in last year's tax reform bill for the Blue Cross and Blue Shield Plans was a significant effort by all parties involved to preserve the beneficial practices of Plans. The special deduction is valuable to Plans, but we submit that it is equally valuable to government and society. As the insurance market becomes more and more competitive -- and that competition is largely based on the ability to reduce premiums by avoiding enrollment of high risk/high cost individuals and groups -- Blue Cross and Blue Shield Plans will have to continue their more liberal practices in order to take advantage of the special tax rules.

Importantly, repeal of the newly crafted provisions would come at the high price of the loss of the incentive for continuation of Plans' community-based services and would generate only a modest amount of new federal revenues. According to estimates of the Joint Committee on Taxation, last year's provisions will result in an estimated $800 million in revenues over 5 years; repeal of the compromise provision would yield only about an additional $100 million over the next 3 years.

With respect to the effect on Blue Cross and Blue Shield Plans, we are barely halfway through our first taxable year after nearly 50 years of being tax exempt organizations. Plans have put enormous efforts into assessing the impact of taxation and adjusting their financial planning so as to continue their services for high risk subscribers. A change in the rules, even before their first taxable year is completed would be extremely disruptive.

## Conclusion

The Tax Reform Act of 1986 has had a profound effect on the Blue Cross and Blue Shield system. Plans came away from last year's debate with an understanding that while not willing to continue the complete tax exemption, Congress did agree to a measure of financial support for valuable business practices. That result was carefully thought through by the tax conferees and will yield an estimated $800 million in federal revenues over five years while establishing an incentive for Blue Cross and Blue Shield Plans to continue their community-based services for the high risk segment of the market.

We respectfully ask that no changes be made to the provisions of the Blue Cross and Blue Shield provisions in the Tax Reform Act of 1986.

## WRITTEN STATEMENT FOR THE RECORD OF W. BEN CRAIN

## ON BEHALF OF THE BURLEY AUCTION WAREHOUSE ASSOCIATION

The Burley Auction Warehouse Association appreciates the opportunity to submit this written statement in opposition to any increase in the federal excise tax on tobacco products.

The members of this association have a unique position from which to view the effects of this excise tax. We operate the warehouses in which burley tobacco farmers market their tobacco. We are acutely aware of the level of purchases by tobacco manufacturers and how well a farmer is doing by his level of sales.

In 1982, when Congress temporarily doubled the excise tax from 8 cents to 16 cents, our association watched the subsequent sale of leaf tobacco immediately decrease. In 1983, the sale of cigarettes declined by 6%. Unfortunately, this reduction coincided with the 1983 drought year for burley tobacco farmers. The resulting economic depression was felt throughout Kentucky and other major burley markets.

Fortunately, steps have been taken to place the American burley farmer in a position where he can, once again, legitimately expect to make a profit from the sale of tobacco. In addition, the prospects of further openings in the international markets are excellent. Burley farmers, although far from being wealthy, are optimistic about being able to service their loan obligations, their quotas being increased and being able to subsidize the balance of their farm operations with the profits from tobacco.

An increase in the tobacco excise tax from 16 cents to 32 cents will immediately put an end to the farmer's optimism. Within the next two years, it is anticipated that the greater percentage of American cigarettes will be made from American tobacco. The decreased dependence on imported tobacco will accrue direct benefit to the American tobacco farmer.

An increase in the tax will cause similar, if not greater, reductions in the need for American tobacco than accured in 1982. We realize several proponents of an increase appreciate, if not encourage, that fact. Nevertheless, the members of our Association are a prime example of the ripple effect of tobacco in the southeastern economy. Although many of our members do not actually produce tobacco, we depend directly on its production and marketing for our livlihoods. There are many other industries similarly situated and this committee must address the adverse economic harm which inevitably will occur if the tobacco tax is increased.

We thank the committee for its consideration of our views and urge its members to oppose any increase in the tobacco excise tax.

Committee on Finance
United States Senate

Washington, D.C.

July 1987

submitted

by

G. Bernard Midden, Jr.
Council for Burley Tobacco, Inc.

My name is G. Bernard Midden, Jr., representing the Council for Burley Tobacco, Inc. I am a tobacco/livestock farmer from Harrison County, Kentucky.

We are all aware of the many problems facing the tobacco industry today, particularly the excessive taxes placed on tobacco products.

There are those who advocate further increases in taxes on tobacco products.

I believe excise taxes are unfair taxes. When the excise tax was increased in 1982 the 55 million people who choose to smoke were singled out and a tax imposed on them. I think this is unequal and unfair taxation.

Farmers, particularly tobacco farmers, are in the worst economic crisis since the depression and excessive taxation is a major cause of the problem.

In 1982, Congress added an additional 8¢ per pack excise tax on cigarettes with the provision for this additional tax to expire October, 1985. As you know the tax was continued and now we have a 16¢ federal excise tax a pack on cigarettes.

Following the imposition of this tax cigarette consumption dropped by 6%. While other factors contributed to the decline in cigarette consumption I am convinced that the additional excise tax was the major factor causing the decline.

The large decline in cigarette consumption impacted directly on farm income from tobacco. It is estimated that the value of the tobacco crop declined by 1 billion dollars in 1983. Part of this decline was due to adverse weather but a large part of the decline in farm income can be attributed to lower consumption of tobacco products caused by increased excise taxes.

During 1984 and 1985 all segments of the tobacco industry worked together to develop a tobacco program designed to cope with declining demand for tobacco products, excess supplies of tobacco in storage and a declining U.S. share of the world market for tobacco.

If excise taxes on tobacco products are increased again I believe that the demand for tobacco products will decrease, the amount of tobacco in storage will increase, our share of the world market for tobacco will decrease, and farm income to the tobacco growers will decrease significantly. I therefore strongly recommend that you do not impose additional excise taxes on tobacco products.

According to Dr. Milton Shuffett, Professor of Agricultural Economics at the University of Kentucky, if excise taxes on cigarettes were increased by 16 cents for example the results would be as follows:

1. Average U.S. price of cigarettes is about $1.00 per pack. The 16 cent tax increase being discussed in Congress would be an increase of 16 percent.
2. Cigarettes consumed would decline by 11.2 percent.
3. Federal revenue from cigarette taxes would increase from $4,331 million collected in 1985-86 to $7,692 million.
4. State tax collections on cigarettes would decline from $4,540 million collected in 1985-86 to $4,032 million or a decline of $508 million.
5. Local excise taxes collected would decline from $199 million to $177 million or a loss of $22 million.

6. State sales tax on cigarettes would average about five percent or about five cents per pack. For the U.S. these taxes total about $1,350 million. Reduction in these collections would amount to about $150 million.

7. Domestic use of burley usually runs about 425 million pounds and most burley is used in cigarettes. Eighty-two percent of cigarettes are tax-paid withdrawals. Consequently, the need for domestic burley would be expected to decline by about 9.2 percent or about 39 million pounds. The average price support level for the 1987 burley crop is $148.80 per 100 pounds. Therefore, this would mean a $58 million reduction in farm income from burley tobacco.

Total farm income from all tobacco is estimated at 2.2 billion dollars and total tax revenues are about 9.5 billion . Tax revenues are more than four times greater than farm income from tobacco. Farm income from burley tobacco dropped by 48 percent from 1984-86. Any further increase in excise taxes will reduce farm income from tobacco.

I appreciate the opportunity to express the position of the Council for Burley Tobacco, Inc. on this important issue.

Thank you.

# Written Statement of Chuck Hassebrook
# on Behalf of the Center for Rural Affairs
# to the Senate Finance Committee
# on the Budget Reconciliation Tax Bill

July 1987

We support four of the revenue raising options offered by the Joint Committee on Taxation including denial of cash accounting to large corporate farms, a longer depreciation term for single purpose agricultural structures, increased taxation on large estates and stricter limits on deduction of farm losses.

These proposals strike at the heart of some of the deepest contradictions in U.S. farm policy; contradictions unfair to both the American taxpayer and the family farmer. While the federal government spent $30 billion last year on farm credit and commodity programs to support farm income, reduce surpluses and help family farmers survive; it was also losing billions of dollars of revenue to corporate farm tax shelters which work in direct contradiction to the stated goals of U.S. farm policy. By granting a disproportionate benefit to high bracket corporate farms, these provisions place low and moderate income family farmers at a competitive disadvantage. They act as magnets for investment in agriculture, with the result that more is produced, lower prices are paid to farmers for their products and Congress is asked to spend more on farm programs to counter the effects.

## Corporate Cash Accounting

The provision that best illustrates these contradictions is the special exclusion for so called "family farms" from the rule denying use of cash accounting to corporations with sales of more than $5 million. Cash accounting grants a powerful competitive advantage to high bracket taxpayers and offers irresistible subsidies to expand production. Any income reinvested in expanding inventories, breeding herds or flocks is fully sheltered from taxation as long as the operation stays at that size or continues to grow. For example, while the federal government paid farmers to slaughter their milk cows through the dairy herd buy out program last year, tax wise corporations used cash accounting to reap tax savings of as much as $400 for each cow added to the herd; like a dairy buy out in reverse. The benefit would be less than half that amount for a family sized farmer in the 15 percent bracket. Unless we want to add to the milk surplus and replace family farms with corporate farms, this is bad public policy and a waste of scarce federal dollars.

The companies which would be weaned of cash accounting by this proposal are fully capable of using accrual accounting. These are not small family farmers. They are large agribusinesses with their own accounting departments. They want cash accounting not for its simplicity, but for a tax shelter. For example, Tyson Foods Inc., one of these so called family farms, received a net tax refund of $1 million on profits of $69 million and annual sales approaching $1.5 billion, from 1981 through 1984. Hudson Foods, with sales of $185 million deferred $7.6 million of taxation in 1985, "playing the loophole with the skill of Stephane Grapelli on jazz violin", according to Forbes Magazine (attached). I am reminded of Justice Stewart's statement in a 1964 pornography ruling, to the effect that he knew pornography when he saw it, and the movie in question was not that. I know a family farm when I see one, and these are not family farms. I urge the committee to treat farm corporations like other corporations and deny them the use of cash accounting if their sales exceed $5 million.

## Single Purpose Agricultural Structures

Single purpose agricultural structures are livestock, dairy and poultry buildings. They are defined as equipment in the tax code, to make them eligible for seven year 200 percent depreciation. The original argument for placing these buildings in the equipment category was that they are an integral part of the equipment they house and therefore their lives end with the equipment. The fact is, however, that the equipment is clearly separable from the structure and routinely replaced. The structure in almost every case has a longer life than the equipment. Attached are copies of letters from Iowa State University Extension Livestock Specialist Earl Mobley and Robert Fritschen, Director of the University of Nebraska Panhandle Extension Station testifying to that point regarding hog production facilities. As regards poultry facilities, land grant universities generally assume a 20 year life for facilities. University of Arkansas Agricultural Economist W. A. Holbrook said in a November 12, 1985 phone conversation that poultry buildings have lives of from 15 to 20 years. He expects their lives to increase as the industry matures and technological obsolescence becomes less of a factor. University of Georgia Extension Poultry Specialist Paul Aho indicated in a July 2, 1987 telephone conversation that poultry equipment has a life of approximately 15 years and poultry structures of approximately 30 years.

Like cash accounting, this inconsistency in the tax code has attracted excess investment to agriculture and changed the rules of competition by granting a competitive advantage to large, high bracket and capital intensive corporate farming operations. For example, Metropolitan Life Insurance Company, in conjunction with Tyson Foods, recently invested $14 million in 200 poultry houses to take advantage of the special tax treatment of these facilities. The facilities are leased to farmers who will use them to raise broilers owned by Tyson Foods, on contract. While this is advantageous to Metropolitan Life, it may not be so beneficial to most broiler growers. The mass introduction of tax subsidized poultry facilities reduces demand for the services and facilities of existing growers. As a result, they will be paid less for them than would otherwise be the case. To make matters worse, the fast write off is worth nothing to many growers. Dr. Holbrook says that most Arkansas growers don't have enough income to use the entire depreciation writeoff on a building in a few years.

The impact is much the same in the hog industry. We used present value analysis to compare the value of speeding up depreciation on these structures to three hog producers; a small beginning farmer with a modest income and low cost facilities; a larger and better established family operation with new facilities and more income; and a large corporate hog operation. The break is worth nothing to the beginning farmer because he has insufficient income to make full use of his depreciation deduction over seven years. To the more established farmer, the break is worth $26.18 per sow in the herd and for the large corporate farm the break is worth $98.91 per sow in the herd. Unless we desire to replace family farms with corporate farms and to block entry into agriculture by young beginning farmers, this is bad public policy and a waste of scarce federal resources. It should be noted that the Farmers Home Administration is spending millions of dollars on programs to help young people enter agriculture, I think justifiably. What is not justified are tax policies which put people with limited financial resources at a competitive disadvantage. I urge that you adopt the proposal to place single purpose agricultural structures in the 15 year depreciation category.

Combined Effect

Together, cash accounting and the special treatment of single purpose structures have a profound effect on the meat and milk sectors. They create barriers to entry, lower profitability, increase the cost of government farm programs and shift control out of the hands of family farmers into corporate hands. One immediate example is the announcement by National Farms, Inc. of plans to build a 300,000 head hog operation in South Dakota. National Farms is undoubtedly a family farmer under current tax policy, because it is family owned by the Bass Brothers of Forth Worth Texas, one of the nation's wealthiest families. Cash accounting could subsidize that expansion by as much as $3 million and the special treatment of single purpose structures by approximately $1.5 million. The additional production is sufficient to displace 300 family sized farms. The additional hogs will reduce by 23 cents to 35 cents per hundred pounds the price paid to family farmers for their hogs across the entire nation.

Death and Estate Taxes

It has been forgotten in recent years that estate taxes were created to foster the broad distribution of property ownership by preventing excessive concentration of wealth. Progressive and effective estate taxation would strengthen family farming. We do not have an effective estate tax today. Well planned gifting and estate programs which make effective use of tax exempt gifts, tenancy in common, special use valuation and the estate tax credit allow families to pass on land approaching $10 million in value, tax free. This is not a policy to save the family farm, but rather the landed gentry. This policy creates stiff competition for family farmers seeking to buy land with the income they earn by farming it. For example, the heirs of a $6 million tax free inheritance could use the unearned rental income from that land to purchase an additional $570,000 of land each year (see the attached analysis). Farmers who must purchase land with what they earn by the sweat of their brow cannot compete with that kind of inherited wealth unfettered by estate taxation, regardless of how efficient and productive they may be. I would suggest that the committee examine a $1 million limit on the amount of wealth which can be excluded from taxation by one family through any combination of these provisions.

As regards taxation of capital gains of estates, I would favor a tax on gains at death rather than reinstatement of the carryover basis. After several generations of accumulated gains, the latter could become a strong disincentive for sale of land and other property. Much farm land would remain in the hands of families long removed from agriculture, rather than being sold to the people who work on it. If a tax on capital gains at death is enacted, I would favor exclusion of the gain on a modest amount of property.

Application of the Rental Real Estate Rules to Farm Losses

I support this proposal, but offer a compromise which addresses the concern that it might discourage needed investment and force sale of land to avoid nondeductable losses. I would apply the rental real estate rules only to farm investments involving cash basis accounting. Accrual basis taxpayers would be unaffected. No profit motivated investment would be discouraged and no one would be forced to sell assets. Yet, many tax motivated investments would be eliminated and competition would be fairer. No longer would tax motivated investors enjoy the advantage over farmers of being able to make money through tax savings without showing an economic profit.

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## CORPORATE CASH ACCOUNTING MEANS CORPORATE FARM EXPANSION

When is a corporation with sales of over $1 billion a family farm? The answer: when corporate farmers and high paid lobbyists go to work on Congress.

Congress warped the definition of family farm to allow corporate giants such as Tyson Foods, Inc., with annual sales of over $1 billion, and Perdue Farms, with sales of over $700 million, to use cash accounting. This tax break is generally denied to corporations with over $5 million sales, except for "family farms". Most corporations are required to use accrual accounting, which means that increases in inventory are counted when computing income for tax purposes. Under cash accounting growth in inventory is ignored. This creates lucrative opportunities for tax avoidance and powerful incentives for expansion. Income reinvested in expanding the inventory is deductable, but the increased value of the inventory is not taxed. That means that each dollar invested in expanding the inventory is sheltered from taxation indefinitely.

Corporate cash accounting is is an invitation to corporate farm expansion at the expense of family farmers. In some cases this makes a mockery of federal farm policy. While the government is paying farmers to slaughter their dairy herds, cash accounting provides tax savings of over $400 for each cow added to the corporate dairy herd. This includes the tax savings from adding a $600 raised heifer to the herd, rather than selling her and realizing taxable income; and the deduction for prepaid feed purchased for the heifer in years prior to its consumption. (Prepaid expense deductions are limited to 1/3 of total farm deductions). In the hog industry, cash accounting subsidizes the expansion of the herd by $215 dollars per gilt added to the herd.

SUBSIDIES FOR ADDING ONE DAIRY HEIFER AND ONE GILT TO THE CORPORATE HERD

| | Swine | Dairy |
|---|---|---|
| A. Value of Raised Heifer/Gilt Not Subject To Taxation | $120 | $600 |
| B. Deduction For Prepaid Feed For One Heifer/Gilt Added to Herd | $513 | $600 |
| C. Total Reduction in Taxable Income (A plus B) | $633 | $1,200 |
| D. Tax Savings Per Heifer/Gilt Added To Herd (Reduction in Taxable Income x 34% Tax Bracket) | $215 | $408 |

Also, cash accounting shelters the value of the calf and pigs produced by the additional heifer/gilt and not sold before year end. This provides an additional $163 (swine) and $75 (dairy) of tax savings. ALSO SEE BACK PAGE

Forbes
May 5, 1986

**Taxing Matters**

*When is a $1 billion agri-industrial complex a family farm? When it comes time to pay the income taxes.*

# Fun and games with chicken feed

**By Ruth Simon**

MOST REASONABLE observers would not call Hudson Foods a family farm. Based in Rogers, Ark., Hudson is now the country's 17th-largest poultry producer. In the fiscal year that ended last Sept. 28, Hudson earned $8.5 million on sales of $185 million. It went public in February, raising $21.3 million.

Your basic family farm? The Internal Revenue Service, not always a reasonable observer, thinks so. As a result, Hudson was able to defer $7.6 million, its entire federal tax bill, last year under long-standing IRS rules. This deferral can be rolled over more or less indefinitely.

Hudson is not a fluke. Other agri-industrial complexes, including $1.1 billion (sales) Tyson Foods and privately held Perdue Farms (estimated sales, $740 million), also routinely receive tax breaks originally intended for family farms. How? By qualifying under some rather arcane rules that allow "family farms" to use cash accounting instead of the accrual accounting the IRS requires most companies to use when computing taxable income. The rules date from 1919, when the Treasury concluded farmers weren't sophisticated enough to use accrual accounting and said they could use cash accounting instead. Big farmers didn't abuse the provision, because taxes were low. Besides, there weren't many big farms.

The choice of cash or accrual is especially important for livestock farmers because such production costs as feed are incurred well before the livestock is sold.

Consider a chicken farmer. Accrual accounting would require him to report a portion of his feed inventories at the end of each year, while not permitting him to expense the feed until the bird was actually sold. The theory is that the feed is an integral part of the cost of producing the bird. Accrual accounting says income and expenses should be matched, so feed costs should not be deducted until revenue is received.

Cash accounting, in contrast, allows the farmer to report cash expenses and receipts when they actually occur. That means the farmer can immediately deduct the feed as an expense, but he doesn't have to report the chickens as income until they are sold. Expensing in the current period while deferring income to a later period amounts to a tax-free loan to the farmer from the Treasury. The bigger and more profitable the farm, the larger that tax-free loan tends to be.

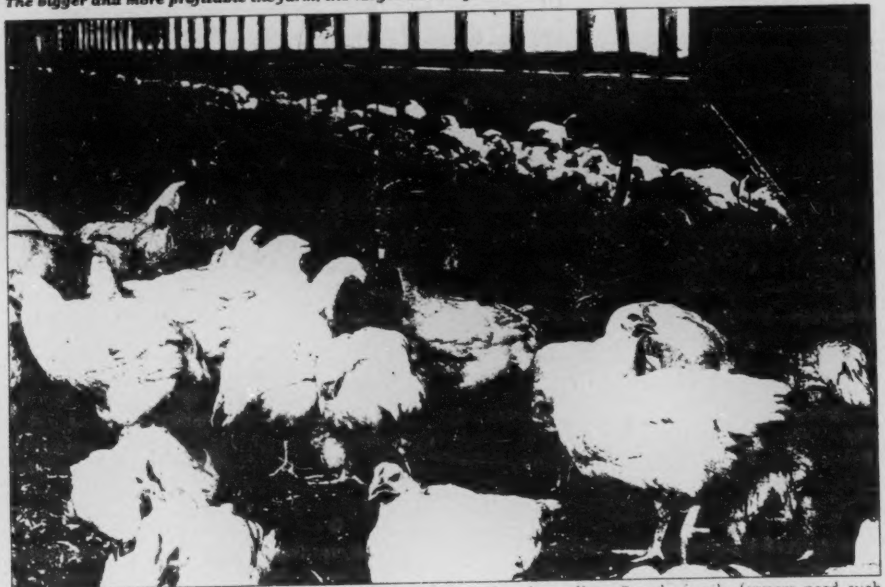
In 1976 the Treasury argued that agribusinessmen were equipped for the rigors of accrual accounting. Treasury tried to limit cash accounting to farmers grossing less than $1 million annually. That sent the big livestock producers squawking to their congressmen, who chickened out. Even a farm grossing $1 billion or more could be a "family farm," Congress said, if at least 50% of its stock was controlled by a single family. It also carved out exceptions for individuals, partnerships and Subchapter S corporations and for farm corporations controlled by two or three families.

Hudson Foods Chairman James Hudson played those loopholes with the skill of Stephane Grapelli on jazz

*Chickens before the slaughter*

***The bigger and more profitable the farm, the larger the tax-free loan. . .***

Grant Heilman/Grant Heilman Photography



violin. Hudson, a former Ralston Purina executive, and two other investors bought the business from Ralston Purina in 1972. Hudson bought out his co-investors in 1984, and took the farm public in February.

But note the key: Hudson Foods has 12 million shares outstanding. James Hudson owns outright 7 million of those shares, 58%, and has the right under a revocable proxy to vote an additional 3 million shares owned by his family and company executives. With Hudson effectively controlling 10 million shares—83% of the common—Hudson Farms can do several more public offerings and still qualify as a "family farm."

Hudson cheerfully agrees "it's been a long, long time" since he drove a tractor. But, he says, "Farming, as defined in the tax code, is the production of farm products. It doesn't matter whether you ride a tractor or a horse." In other words, says Hudson, all farmers are created equal and should be treated equally by the IRS.

Springdale, Ark.-based Tyson Foods, the nation's second-largest poultry producer (after ConAgra), is also proving adept at playing by the family farm rules. This $1.1 billion agricompany contracts out chicken production to thousands of small farmers, and it derives more than 60% of its revenues from such "further processed products" as Chicken McNuggets and frozen dinners.

To remain a family farm—but also raise public equity—Tyson recently reincorporated in Delaware, where it can issue two classes of stock. The Tyson family will trade its 55% Class A holding for restricted Class B shares that carry ten votes each. Outside shareholders can keep the Class A shares or swap them for Class B, which pays a lower dividend. If only the Tysons make the switch, they will control 92% of the voting rights—far above the magic 50% minimum. Any new stock issued by Tyson will be of the Class A variety.

Important? It is to Tyson. Tyson earned $35 million in the fiscal year that ended Sept. 28. Cash accounting allowed it to defer about $26 million in taxes. That amounted to 78% of Tyson's 1985 federal tax bill.

"We consider ourselves as an umbrella over about 6,000 farms and farm families," says Chairman Don Tyson, defending his use of the family farming rules. "If we didn't have this kind of situation, we couldn't protect those 6,000 farmers."

But do family farmers need such protection? The fact is, cash accounting often works against farmers by making cattle, hogs and certain orchards attractive tax shelters and by encouraging overproduction. "I've seen too many instances where egg producers or others on a cash basis will expand their operation to avoid paying income tax," says Agriculture Secretary Richard Lyng, who was briefly on Hudson Foods' board. "That kind of tax policy has caused family farmers a lot of trouble."

Chuck Hassebrook of the Center for Rural Affairs in Walthill, Neb. agrees. "Cash accounting," he warns, "really distorts supply and demand." And Tyson may soon freeze the amount it defers because tax factors are warping its business decisions.

This seems like just the kind of loophole genuine tax reform should plug. Indeed, the Administration's reform proposals would have limited cash accounting to companies with less than $5 million in gross receipts. But the big farmers and their lobbyists squawked as in 1976, and congressmen again clucked. Reforming farmers' cash accounting was one of the first proposals to be dropped last year by congressional tax writers. ■

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JUN 1984
RECEIVED
FOR
AFFAIRS

June 4, 1984

Bruce Davies
House, Ways and Means Committee
1136 Longworth HOB
Washington, D.C. 20515

Dear Mr. Davies:

I recently had a conversation with Mr. Chuck Hassebrook in regard to tax laws for agriculture. Specifically we addressed the issue of single purpose buildings and their related tax depreciation schedules. He asked me if I would review with you what most of my pork producers who are on an enterprise record program do with their depreciation schedules.

Normally the people I work with use ten year depreciation schedules for their swine buildings. In most instances, the equipment on the interior of the building is on a five to seven year schedule. We don't expect the panels separating pens, feeders and other equipment to last much longer than five to seven years. The building would normally be expected to last for fifteen to twenty years.

In my opinion, the new tax laws allowing a five year depreciation write off definitely favors non-agricultural capital investment. I personally believe the tax depreciation laws should be realistic and somewhat close to the normal expected lifetime of a given building or equipment.

Hope this information may be of some value to you. If I can be of any more service, please feel free to contact me.

Respectfully yours,

Earl Mobley

Earl D. Mobley
Extension Livestock Production Specialist

EDM/cs

cc: Chuck Hassebrook ✓

. . .AND JUSTICE FOR ALL

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*Iowa State University and U. S. Department of Agriculture cooperating*

**Cooperative Extension Service**
Institute of Agriculture and Natural Resources
University of Nebraska–Lincoln

Panhandle Station
4502 Ave. I
Scottsbluff, NE 69361
308-632-1230

June 5, 1984

**TO:** Chuck Hassebrock
Center for Rural Affairs
Walthill, NE 68067

**RE:** Buildings versus Equipment

There is a distinct difference between buildings and equipment as related to swine facilities, or nearly any other structure involved in agriculture.

Specifically in swine production, the building is simply a physical boundry referred to as a structure, that allows us to arrange the equipment in such a way to enhance production. A building is the frame that surrounds the equipment.

In this case the equipment would be farrowing crates, pens, feeders, or pen dividers.

The building may be used for other than the original purposes, but the equipment is useful, almost exclusively, only for the original designed purpose.

Again, in the case of swine facilities, much of the equipment is worn out in five to eight years, while the building that houses the equipment, with on-going maintenance, lasts for more than twice this period.

Sincerely,

Robert D. Fritschen

Robert D. Fritschen
Director

RDF:bj

UNIVERSITY OF NEBRASKA–LINCOLN, COOPERATING WITH THE COUNTIES AND THE U.S. DEPARTMENT OF AGRICULTURE

University of Nebraska–Lincoln University of Nebraska at Omaha University of Nebraska Medical Center

# CENTER FOR RURAL AFFAIRS

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## TAX BREAK ON LIVESTOCK AND POULTRY BUILDINGS HURTS FAMILY FARMERS

When the House and Senate each completed their versions of the tax reform bill in 1985 and 1986, they both agreed that one widely abused tax shelter should end. Livestock, dairy and poultry buildings had been defined as equipment for tax purpose to qualify them for an unrealistically short depreciation term. The irrational provision encouraged more expansion in an industry already burdened by overproduction and placed family farmers at an unfair competitive disadvantage with large corporate farmers who could better exploit the break. Nonetheless, when the conference committee revealed its version the corporate farmers had won. The tax shelter survived.

The following example compares the benefit of this break to three different hog producers: a 15% bracket beginning farmer with 40 sows and $15,000 invested in remodling old barns; a 15% bracket, 100 sow established farmer with $60,000 and some of his own labor invested in new farrowing, finishing and nursery buildings; and a 34% bracket 10,000 sow corporate operation with $10 million invested in new buildings*. We measure the value of the break by comparing the present value of the tax savings under the seven year equipment depreciation schedule with the present value of the tax savings under the 15 year depreciation schedule, which is more reflective of the buildings' useful lives.* This the interest value of having the savings sooner under a faster writeoff. The break is worth nothing to the beginning farm couple, making $18,000 per year. Accelerating the depreciation creates more writeoffs than they have taxable income, causing them to forfeit part of the standard deduction and personal exemptions for their family of five. The established family farmer gets only one fourth the break as the large corporate farm. The break is worth more the higher the tax bracket and the more invested in facilities (capital) to replace labor.

### VALUE OF ACCELERATING DEPRECIATION ON HOG BUILDINGS

| | Beginning Farmer 15% Bracket | Established Farmer 15% Bracket | Corporate Farm 34% Bracket |
|---|---|---|---|
| Benefit Per Sow In Herd | 00.00 | $26.18 | $98.91 |
| Hog Price Increase Of Equal Value To The Break*** | 00.00 | $.08 | $.31 |

The Long Term Cost - Because this break encourages more building and production, it lowers hog prices. The established farmer's $.08 per 100 lbs. tax benefit will be more than lost by the price impact of just 100,000 additional corporate hogs. The 7,000 sow expansion by Murphy Farms, Inc. (of North Carolina) in 1986 will cost more in lower hog prices than the average farmer gains from rapid depreciation of hog buildings.

*Building costs include structures only; not equipment.
**We use a 10 percent discount rate.
*** Per 100 lbs produced over 15 years, discounted to present value at 10%

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## ESTATE TAX LOOPHOLES PAVE THE WAY TOWARD A LANDED GENTRY

The estate tax could contribute to the survival of family farm agriculture by discouraging the concentration of land in a few wealthy hands. Wealth begets more wealth in a capitalist economy. Without measures such as estate taxes to offset the resulting concentration, wealthy people can pyramid ever greater amounts of wealth upon their initial advantage, until economic control rests in a few hands and opportunity is lost to all but those born to wealth.

Unfortunately, current estate and gift tax laws are so full of loopholes as to be largely ineffective. In the following example, a wealthy couple passes on 10,000 acres of land tax free, worth $6 million. After retirement, the parents make tax free gifts of $20,000 worth of land each year to each of their 12 heirs (four children and eight grandchildren). After fifteen years they have distributed $3,600,000 worth of land. When they die, the remaining $2,400,000 worth of land will be reduced to $1.2 for estate tax purposes through the use of special use valuation. The remaining $1.2 million will be entirely free from taxation under the estate tax credit, which exempts $600,000 per person.

Through their $6 million inheritance, the heirs gain an advantage over smaller farmers and use that advantage to buy an additional 950 acres each year. They form four family corporations and farm the land. After expenses and paying salaries to family members, the corporations receive a six percent return on the $6 million of inherited land, for a total of $360,000 per year; $284,600 after income taxes. This is the "unearned" portion of their income. It is what they could earn by cash renting the inherited land to other farmers. The unearned income is sufficient to make a 50 percent down payment on 950 acres of $600 per acre land each year. With the down payment and a 10 percent interest rate insurance company loan, the land cash flows.

Can efficient smaller farmers who must buy land with income they earn by farming, rather than returns on large inheritances, compete with this family for land? Is this fair competition? Will opportunity to own land be limited to high income investors and people born into wealthy families?

Six Million Dollars Worth of Land Inherited Tax Free

| | |
|---|---|
| Tax Free Gifts | $3,600,000 |
| Reduction of the Estate Through Special Use Valuation | $1,200,000 |
| Estate Tax Credit ($600,000 Each for the Mother and Father) | $1,200,000 |
| Total Tax Free Inheritance | $6,000,000 |

## STATEMENT OF THE CEO TAX GROUP

The CEO Tax Group is a group of chief executive officers of major corporations that strongly supported -- and still strongly supports -- the income tax reforms enacted last year -- and especially the lower tax rates under that law.

The CEO Tax Group believes that the Congress and the Administration made a compact with U.S. taxpayers -- both individuals and corporations -- that if taxpayers were to lose many of their tax preferences, they would receive lower tax rates in return. Individuals and corporations have given up a substantial number of their tax preferences, even though the low rates that were traded for are not yet fully effective.

If Congress decides to raise the individual and corporate rate structures, it will be repudiating its compact and breaking its word with the American people. In addition, enormous pressures would be applied to restore preferences repealed or curtailed in last year's Act.

Since the enactment of TRA '86, a major goal of the legislation has been achieved: investment decisions are being made based on economic, rather than on tax consequences.

The CEO Tax Group urges Congress to leave the phased-in rate structure in place, so that its beneficial economic effects may be felt and individuals and the business community can assess its impact. Many corporations -- because of the way their fiscal years are set up -- have yet to feel the first reduction in the top marginal rate for corporations. Individuals across the nation have yet to feel the full effect of their substantially reduced rates, although they have lost many of their preferences.

Tax reform would not have been possible without a substantial reduction in the tax rates on individuals and corporations. Indeed, the economic benefits that would flow from **low rates** were the primary driving force behind the tax revision effort.

**Low rates** led some members of Congress to craft tax reform proposals, and led President Reagan to instruct the Treasury Department in his 1984 State of the Union message to develop a tax reform package for fairness, growth, and simplification.

The promise of **low rates** successfully helped the Committee on Ways and Means to take the lead in writing tax reform legislation in 1985.

**Low rates** revitalized tax reform in the Finance Committee in 1986, and **low rates** helped the conferees withstand enormous pressures and subsequently achieve the Tax Reform Act of 1986.

The CEO Tax Group views the current budget deficit as an extremely serious problem. As difficult as the task before you is, we urge this committee not to fashion a deficit reduction proposal that changes or delays the fundamental cornerstone of tax reform -- the income tax rate reductions.

Allied-Signal, Inc.
Beneficial Corporation
Dayton Hudson Corporation
Emerson Electric Co.
Federated Department Stores, Inc.
General Foods Corporation
General Motors Corporation
Hallmark Cards, Inc.
Hewlett-Packard Company
IBM Corporation
J. C. Penney Company, Inc.
Kraft, Inc.
Levi Strauss & Co.
Merck & Co., Inc.
3M Company
Pepsico, Inc.
Pillsbury Company
Primerica Corporation
Procter & Gamble Company
Sara Lee Corporation

CTJ

Citizens for Tax Justice

## Statement of Robert S. McIntyre
## Director, Citizens for Tax Justice
## Before the Senate Committee on Finance
## Concerning Ways to Increase Revenues
## To Meet the 1988 Budget Targets
## Submitted July 16, 1987

Less than a year ago, Congress enacted the Tax Reform Act of 1986. It was a monumental achievement, restoring a measure of fairness to an income tax system that was sadly in need of repair. The tax reform act went a long way toward assuring that those with the greatest ability to pay taxes would no longer be able to escape their responsibilities entirely, while giving relief to those less able to pay. Now Congress and this Committee face a new challenge: to raise the revenues needed to meet the fiscal 1988 budget targets without undermining the fairness gains instituted last year.

Raising taxes, or, for that matter, cutting spending, is never a happy task. But we believe that this year's revenue bill should be seen not simply as a burdensome chore, but also as an opportunity—an opportunity to continue the progress toward a fairer tax system begun in 1986.

The staff of the Joint Committee on Taxation has compiled a long list of potential revenue-raising measures for the Committee's consideration. In choosing among them, we hope that the Committee will keep the following principles in mind:

**1. Congress should avoid regressive tax increases that undermine the benefits middle- and low-income families gained from last year's tax reform act.**

**2. Further loophole-closing measures that preserve and extend the tax reforms enacted last year should be given the highest priority.**

**3. At a time when tax *increases* are necessary, further tax *cuts* that would benefit the wealthiest segments of our society should be eschewed.**

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## 1. The Trouble With Regressive Excise Taxes

The biggest threat to tax reform is that Congress may attempt to meet its 1988 budget targets through stiff increases in federal excise taxes.

One set of options outlined in the staff pamphlet is to increase excise taxes on gasoline, alcohol, tobacco and telephone services. For example, adding 12 cents a gallon to the gasoline tax, 49 cents to the tax on a six-pack of beer and 52 cents to the tax on a bottle of wine, doubling the 16-cents per pack cigarette tax and extending the scheduled-to-expire three-percent telephone tax would raise just about the amount Congress needs to meet its three-year revenue target. More than half of that money would come from the increase in the gasoline tax, which raises almost $1 billion for every penny added to the tax.

What's wrong with higher excise taxes? What's the big deal about asking people to pay an extra half a buck for beer or wine, and an extra dollar and a half to fill their gas tanks? The answer, in a nutshell, is that these taxes are an extremely regressive way to pay for government.

According to a January 1987 Congressional Budget Office study, the just-described package of excise tax increases would cost families earning less than $10,000 a year more than 2½ percent of their incomes. That's more than double the tax cut the poor gained from last year's tax reform act. Middle-income families would pay about one percent of their earnin[illegible] in increased excise taxes—again, more than they will save in income taxes from [illegible] 1986 reform act. But the richest families, those making more than $200,000 a year, would pay a mere 1/10th of a percent of their incomes in higher excise taxes, meaning that they'd keep most of their 1986-enacted tax cuts.

### Effects as Shares of Family Income Of Meeting the Budget Targets With Excise Taxes

**(Raise Gasoline Tax by 12¢/Gallon; Beer Tax by 49¢/Six-Pack; and Wine Tax by 52¢/Bottle. Double Tobacco Tax & Extend Telephone Tax)**

| Family Inc. | Gasoline | Beer | Wine | Tobacco | Tele. | TOTAL | 86 Tax Cut |
|---|---|---|---|---|---|---|---|
| **Below $10,000** | 1.1% | 0.5% | 0.2% | 0.6% | 0.3% | **2.7%** | **-1.1%** |
| **$10-20,000** | 0.7% | 0.3% | 0.1% | 0.3% | 0.1% | **1.5%** | **-1.3%** |
| **$20-30,000** | 0.5% | 0.2% | 0.1% | 0.2% | 0.1% | **1.2%** | **-0.8%** |
| **$30-40,000** | 0.5% | 0.2% | 0.1% | 0.2% | 0.1% | **1.0%** | **-0.8%** |
| **$40-50,000** | 0.4% | 0.2% | 0.1% | 0.1% | 0.1% | **0.8%** | **-1.0%** |
| **$50-200,000** | 0.3% | 0.1% | * | 0.1% | 0.1% | **0.6%** | **-0.3%** |
| **Over $200,000** | * | * | * | * | * | **0.1%** | **-0.5%** |

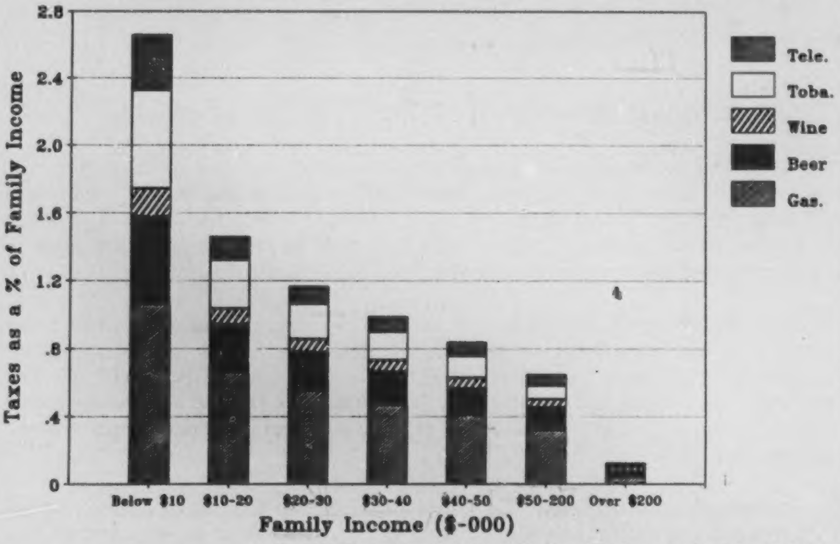
*Less than 0.05%

*Sources: CBO, Consumer Exp. Survey, Jt. Comm. on Taxation.*

Such a package of excise tax increases would take 21 times as big a share of income from the poor as from the richest people. And a similarly skewed distribution of tax increases would occur no matter which combination of excise tax hikes might be concocted.

Excise taxes don't take a larger share of income from poor and middle-income families because these families drive more, smoke more, talk on the phone more or buy more alcohol than the rich. To the contrary, the less a family makes, the less it typically spends on all these items. The problem is that the amounts spent by poorer families are a much larger share of their limited earnings. For example, the $900 that a family earning between $10,000 and $20,000 typically spends on gasoline amounts to about 6 percent of the family's earnings. In contrast, the $1,800 that a very rich family (making more than $200,000) spends for gasoline is less than 0.3 percent of its income.

**Raising Revenues With Excise Taxes**
**Effects on Family Income of a $20 Billion/Year Package Affecting Gasoline, Beer, Wine, Tobacco & Telephone***



*Gas. $.12/gal.; Beer $.49/six-pack; Wine $.52/bot.; double Tob.; keep Tele.

The prospect of higher federal excise taxes looks even worse when the situation in the states is taken into account. Most states and some local governments also tax gasoline, tobacco, alcohol and telephone service, and these taxes have been going up dramatically in recent years. As a result, higher federal excise taxes would come on top of an increasingly regressive total national excise tax structure.

For example, at present, the average federal and state tax on gasoline is 21½ cents per gallon and the average federal and state tax on cigarettes is 33.9 cents per pack. This year, eleven states already have increased their gasoline taxes and four have raised their cigarette taxes. Last year, there were ten state gasoline tax hikes and thirteen state cigarette tax increases.

Moreover, higher gasoline taxes, in particular, would create significant regional disparities. Washington, D.C., with its extensive system of public transportation, has the lowest gasoline consumption per capita in the United States, but the situation is quite different in less densely populated places. Geographically, the big potential losers from a gasoline tax live in the south and the west. According to a 1986 study by the Social Welfare Research Institute, South Carolina, Wyoming, Montana, South Dakota, Arkansas, Mississippi, Alabama, Tennessee, New Mexico and Utah would be the ten hardest hit states when it comes to a gasoline tax hike as a share of personal income.

Increased excise taxes, proposed tariffs on imported oil or suggestions for some kind of new national sales tax, all share a common defect: they would put almost all the burden of deficit reduction on those least able to afford it. And, by doing so, these kinds of tax increases threaten to sabotage the fairness gains of last year's tax reform act. Fortunately, higher excise taxes are not the only alternative before the Committee.

## 2. Continuing in the Spirit of the 1986 Reform Act.

Last year's reform act did a great deal to restore fairness to the federal income tax code, by cracking down on many tax freeloaders and by making it more likely that people with similar incomes will pay about the same amount in taxes. But the task of tax reform is not over. In fact, only by continuing in the spirit of the 1986 act can Congress preserve the victories that were won last year.

Even the President, in the budget he sent to Congress, was able to find one "loophole" in the revised tax code that he thought cried out to be closed: the tax exemption for black lung benefits received by disabled coal miners. While this item is not high on our list, its inclusion in the President's budget does suggest that loophole-closing is one avenue of deficit reduction that may be negotiable with the administration.

And as the staff pamphlet illustrates, there are, in fact, numerous loopholes left over after tax reform—loopholes that, we believe, ought to be narrowed or closed as ways to meet the budget targets. Without repeating all of the details in the pamphlet, we'd like to highlight several items here:

### a. Preserving the corporate tax:

Over the past several years, and increasingly in recent months, large, corporate-like entities have been formed or restructured as publicly-traded partnerships—so-called "Master Limited Partnerships." These entities have been established in a wide and growing range of activities, including elderly care, energy, real estate, portions of Burger King, leasing, gambling casinos, industrial-parts distributors, and even the Boston Celtics. The purpose of using the partnership form is simple: to avoid the payment of the corporate income tax.

Indeed, master limited partnerships (or "MLPs") are nothing but publicly-traded corporations masquerading as a partnerships. Partnership units in MLPs are sold on the stock exchange just like shares of stock. Limited partners in an MLP do not participate directly in the management of the company and are not liable for the debts of the company, just as shareholders don't manage and are not liable for the debts of a corporation whose stock they own.

The big difference between a corporation and a master limited partnership involves taxes:

- As a corporation, a company pays income taxes on its taxable profits each year. When profits are distributed to shareholders as dividends, the dividends are included in the taxable income of shareholders (except those that are tax-exempt, such as pension funds, foundations, or (mainly) other corporations).
- If a company is set up as a master limited partnership, there is no corporate income tax. Owners of partnership units are taxable on their share of the company's earnings each year (whether or not the profits are paid out to the owners).

The Treasury Department has recommended taxing so-called "Master Limited Partnerships" as corporations. We support this recommendation. Like the Treasury Department, we are deeply concerned about the growth in master limited partnerships. In the long run, these devices threaten to undermine the just-revitalized corporate income tax.[1] In addition, MLPs have the potential to sabotage the new individual alternative minimum tax (by generating "passive income" to soak up tax-shelter losses), and they create mind-boggling audit and collection problems for the Internal Revenue Service.

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[1] Those who defend MLPs have argued that they serve to mitigate the so-called "double" taxation of corporate profits. In fact, however, "double" taxation is largely a myth, even after tax reform.

In 1985, approximately 39 percent of corporate profits were subject to corporate income tax. Dividends reported on personal tax returns (representing just over 40 percent of total dividends paid, excluding intercorporate dividends) amounted to 15 percent of corporate profits, and net capital gains on corporate stock reported on personal tax returns totaled 5 percent of corporate profits. Thus, less than 60 percent of corporate profits were subject to tax—notwithstanding the so-called "double tax." [The total effective tax rate (both corporate and personal) on corporate profits totalled about 25% in 1985.] In comparison, essentially all cash wages were reported on personal tax returns.

The under-taxation of corporate profits is lessened under tax reform. In 1988, approximately two-thirds of corporate profits will be subject to corporate income tax. When dividends and capital gains reported on personal tax returns are added in, a total of almost 90 percent of corporate profits will be subject to tax. [In 1988, when rate reductions are factored in, the effective corporate and personal tax rate on corporate profits will total about 28%—an increase of about 13 percent compared to 1985.] But the share of corporate profits that are taxable is still below the share of cash wages that are reported on personal tax returns.

We recommend that master limited partnerships be treated as corporations (with only a short transition period for existing MLPs to restructure their affairs).

In addition, we believe that the Committee should go further in examining partnership issues and in curbing the growth in other avoidance devices that also threaten the integrity of the corporate income tax. For example, the trend in recent years of companies substituting debt instruments for stock raises serious concerns. We recommend that the Committee consider denying interest deductions for over-leveraged corporations, and also consider treating profit-contingent "interest" payments as non-deductible dividends rather than as deductible payments.

**b. Depreciation reform:**

According to the Joint Committee on Taxation's most recent tax expenditure analysis, by far the biggest tax break left for corporations in the reformed tax code is the still excessive system of write-offs for depreciation, which is expected to cost a staggering $227 billion over the next five years. Slowing down the rate of acceleration—by using 150-percent declining balance where double-declining balance is now allowed, and substituting 125-percent where 150-percent is now prescribed—would stanch this revenue hemorrhage. Or, at least, the Committee could make some sense out of the depreciation rules for leased equipment. Right now, to qualify as a "true lease" for tax purposes, taxpayers have to aver that the machinery being leased has a useful life of no less than 125 percent of the lease term. (Otherwise, the deal wouldn't be a lease; it would be an instalment sale.) So why not take the lessors and lessees at their word, and make the write-off period for leased property be, at minimum, 125 percent of the lease term?

**c. Tax-benefit transfers:**

One the tax scandals of the early 1980s was the practice (briefly sanctioned by the 1981 tax act) of companies buying and selling excess tax benefits. This practice continues to some extent, and we believe it should be curbed. In particular, we recommend that the committee examine some of the problems outlined in the staff pamphlet involving tax-benefit mergers, sales of losses using preferred stock and abuses of consolidated returns (notably involving corporate ownership of property and casualty insurance subsidiaries).

**d. Accounting issues:**

The staff pamphlet points to a number of problems in tax accounting that we believe the Committee should address. In particular, the continued use of "completed-contract accounting," most notably by defense contractors, should be eliminated.

**e. Foreign issues:**

The staff pamphlet also points to several problems in the foreign area that we believe should be corrected. Notable among these are: the source rules for allocating profits between domestic and foreign sources and the allowance of tax deferral on runaway plants, both of which can provide incentives for companies to divert resources and jobs to overseas operations, and the lack of a withholding tax on foreign investors, which encourages international tax evasion and hurts our trade balance by artificially supporting the value of the dollar.

**f. Business meals:**

Newspaper reports make clear that the posh restaurant business is not suffering from the tax reform act's restriction on business meal deductions to 80 percent of what's spent. So why not lower to the deduction to 50 percent—and raise $6.6 billion over the next three years? Why should American taxpayers still be subsidizing the eating habits of the well off?

**g. Corporate and tax-shelter farming:**

There was a lot of talk last year about getting rid of tax-shelter farming, but the restrictions on deductions for so-called farm "losses" could use some more teeth. Right now, all a tax-shelter farmer has to do to avoid the "passive loss" restrictions is make sure he or she plays a minimal "management" role in the farm operation. Abuses in this area could be curbed by treating farm "losses" the same as real-estate "losses"—by definition, not allowed to shelter non-farm income once "losses" exceed a certain amount. At the same time, if Congress really is concerned about bona fide family farms, corporate farm losses ought to be subject to the passive-loss limits and large farms should no longer be allowed to use the "cash accounting" system designed to simplify bookkeeping for small farmers.

**h. Capital gains on inherited assets:**

Taxing capital gains when people die, instead of letting heirs inherit property and stocks with the taxes on built-up capital gains totally forgiven, could raise more than $10 billion over the next three years, and reduce the current disincentive for people to sell things while they're alive. (Special rules for farms and small businesses could be drafted to deal with particular problems in these areas.)

**i. Home-equity loans:**

People who are worried (rather than ecstatic) about the boom in home-equity loans probably have a point. The limits on consumer interest deductions were not sufficiently thought through last year. If Congress is serious about those limits, mortgage interest deductions should be limited to loans taken out to purchase or improve a home (with refinancing still allowed up to the amount owed on an acquisition-connected loan). This approach would retain the tax break for home purchases, but avoid the revenue losses and enforcement problems associated with the current rules.

**j. Alternative minimum tax:**

Strengthening the alternative minimum tax for individuals and corporations—by broadening the base or increasing the rates—should also be considered by the Committee. Insofar as the minimum tax base is brought closer to actual profits or earnings, and insofar as the rates are brought closer to the rates in the "regular" personal and corporate taxes, the minimum tax will do a better job of assuring that those with the greatest ability to pay taxes are actually paying their fair share of the tax burden.

## 3. Will Congress raise taxes to pay for tax cuts for the wealthy?

The debate over raising taxes to meet the fiscal 1988 budget targets comes at a time when, under previously enacted tax legislation, tax cuts are scheduled to go into effect starting on January 1, 1988 that mainly will benefit the very wealthiest Americans. We believe that the Committee should consider deferring or repealing these scheduled tax cuts, rather than raising taxes on middle- and low-income families.

Next year, unless Congress acts, the top estate tax rate is scheduled to drop from 55 percent to 50 percent. Freezing the top estate tax rate at 55 percent would avoid $500 million in revenue losses over the next three years—and stop the ongoing decline in the estate tax. Only the very largest estates (those worth well over $2 million) would be affected by this freeze.

Finally, Congress should take another look at income tax rates. On January 1 of next year, the rate on the highest income people is scheduled to drop from 38½ percent to 28 percent. If that occurs, half of the richest people in the country will end up with tax cuts averaging more than $50,000 each. Freezing the top income tax rate at its 1987 level of 38½ percent for people making more than $200,000 would be consistent with the House-passed version of the 1986 tax reform act, and could avert as much as $20 billion in 1988 tax cuts for the very wealthy (depending upon the treatment of capital gains). Indeed, merely extending the 33 percent top rate, which is currently scheduled to apply to taxable income between $71,000 and $192,000, to taxable income above $192,000 would raise close to $9 billion per year—all of it from the richest one percent of the population.

Some have argued that the scheduled income tax cuts for the rich are sacrosanct, that they are part of a pact with the American people that must not be broken. But the public does not agree with that position. Indeed, a recent poll found that, by a three-to-one margin, the public supported freezing the top tax rate instead of increasing excise taxes.

## Conclusion:

Last year, this Committee played a key role in the most sweeping reform of the income tax in memory. This year, the Committee faces the job of increasing taxes. We hope the Committee will treat its task as an opportunity to further the goals of tax reform—and not undermine reform with regressive tax hikes that reverse the progress of last year.

# STATEMENT OF
# THE COMMITTEE OF ANNUITY INSURERS
# ON
# PROPOSALS CONTAINED IN THE JOINT COMMITTEE ON TAXATION'S "DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES"
# FOR HEARINGS HELD BY THE FINANCE COMMITTEE ON JULY 15 - 17, 1987

The Committee of Annuity Insurers appreciates this opportunity to advise the Committee on Finance of our concerns with proposals contained in the Joint Committee on Taxation's "Description of Possible Options to Increase Revenues" that would adversely affect nonqualified deferred annuity contracts. The Committee of Annuity Insurers, a coalition of 26 of the leading annuity writers in the United States, was formed in 1981 for the purpose of monitoring legislative and regulatory issues affecting the annuity issuer and the annuity policyholder. A list of our member companies is attached.

The options list presented for the Committee's consideration includes proposals that would change dramatically the tax treatment of the inside build-up on nonqualified deferred annuity contracts. The Committee of Annuity Insurers strongly opposes such changes and urges Congress to reject once again these proposals, as it did just as recently as last year. Before turning to the merits of the proposals being advanced, it is essential to fully understand the unique characteristics of a nonqualified deferred annuity contract, and to review the present tax laws governing deferred annuities and the policy behind such tax laws.

Deferred annuities are a well-suited means of providing income security during an individual's retirement years. The purchase of an annuity confers on the policyholder a guarantee that, at retirement, these savings, plus interest, will be returned in the form of a stream of payments that will continue for the remainder of the policyholder's life. An annuity is therefore the most convenient and complete method available today for providing for supplemental retirement income and for ensuring against the risk that the individual may outlive the means of his or her support.

Most importantly, it must be reiterated that the annuity contract is not a tax avoidance device. The premiums for a nonqualified annuity are paid in after-tax dollars, that is, such premiums are not deductible from gross income. Furthermore, current law does not allow interest on annuities to escape tax. All income credited to the contract is taxed at ordinary income tax rates when the money actually is received by the policyholder.

In 1982, 1984, and 1986, Congress, after exhaustive review, made substantial changes to the tax treatment of annuities to ensure that such contracts are utilized for long-term investment and retirement purposes. As a result of these changes, and as is pointed out in the options pamphlet, if a policyholder makes a premature withdrawal from an annuity contract, the amount withdrawn is considered to come from the gain that has accrued under the contract (the inside build-up) and is thus currently taxable to the policyholder. In addition, with limited exceptions, a penalty tax of ten percent is imposed on withdrawals from a deferred annuity that occur before the owner has reached age 59-1/2. For these purposes, a loan against, or pledge of, the annuity contract is treated as a taxable distribution. Furthermore, to curb any potential for continuing deferral after the death of the annuity policyholder, present law requires (except in the case of a surviving spouse) that distributions be commenced at the time of a policyholder's death.

These rules collectively have established a framework which assures that favorable tax treatment is available only to those products that fulfill their historical purpose -- to provide retirement income. At the same time, they preserve the tax treatment which, for sound reasons of national policy, Congress has extended to these contracts since 1913.

Now, the Committee on Finance has been presented with two proposals affecting the tax treatment of annuity contracts that specifically were considered by Congress just last year. One option suggested for the Committee's consideration would tax an annuity policyholder currently on the interest credited to his or her annuity contract (the inside build-up). An alternative proposal would limit the amount that a policyholder could invest in a newly-issued annuity contract on a tax-deferred basis. These issues have been thoroughly examined and rejected by Congress in the past, and for the reasons discussed below, we believe this Congress should do likewise.

Under the first option, the owner of an annuity contract would be treated as being in receipt of the contract's cash surrender value, even though the policyholder has not received these amounts either directly or constructively. Thus, the policyholder would be placed in the position of paying a tax on income he or she cannot effectively receive if the policyholder wishes to retain the basic benefits that were acquired with the purchase of the annuity. As a result, the policyholder would incur ongoing negative cash flow (because of the tax paid) for the privilege of purchasing the annuity.

Under existing law, as discussed above, the owner of an annuity contract is taxed only when certain contract distributions occur. This follows the time-honored doctrine of "constructive receipt," which holds in part that potentially taxable gains that are "locked up" in property, and therefore not reducible to cash without surrender of valuable rights in that property, do not properly constitute income currently subject to tax. The options proposal, if adopted, would override the doctrine of constructive receipt in the case of annuity contracts, and would tax inside build-up as it arises. By so doing, the proposal would depart from well-established tax principles that generally continue to be accepted. There has been a long-standing and understandable hesitation to levy a tax on income that exists only theoretically in a taxpayer's hands, since the tax must be paid with cash rather than with theories. To force the owner to pay tax currently on gains locked up inside an annuity contract would present very real problems to the owner. Not only would such treatment represent a funadamental change in the taxation of annuity products, it is contrary to both sound tax policy and sound retirement policy.

Similar arguments can be advanced against the second option which would limit the amount of premiums that an individual may pay for an annuity contract and not be taxed currently on the income credited to the contract. It is not possible to determine a "perfect" annuity premium amount that would account for the retirement needs of every individual and his or her family. Individuals who live in high cost areas, or who have obligations that extend beyond their working years might find it necessary to set aside larger amounts of monies for their retirement. If Congress arbitrarily imposes a premium limit, these individuals would be forced to restrict their contributions or be placed in the position of paying taxes on income they have not actually received.

In addition, it has been suggested that a limit may be appropriate in light of the fact that present law places certain restrictions, such as nondiscrimination rules or contribution limits, on other types of retirement devices. However, such an argument fails to take into account that these "qualified" retirement vehicles are funded with tax-free dollars, while no special tax deduction is allowed through the payment of a nonqualified annuity premium. Furthermore, the present law nondiscrimination rules for qualifed pension plans primarily are designed to limit tax-deductible employer contributions to those plans which do not discriminate in favor of the highly-paid. A rule addressing such a concern has no application to the individual that purchases a nonqualified deferred annuity contract with his or her own after-tax dollars.

Most importantly, this concern that nonqualified annuities "circumvent important rules applicable to qualified plans" was specifically addressed in the Tax Reform Act of 1986 where Congress revised the tax treatment of nonqualified annuities to provide that the inside build-up on corporate owned annuities would be subject to current taxation. These changes were made for the express purpose of ensuring that deferred annuity contracts could not be used to fund, on a tax-favored basis, deferred compensation of employees outside of the restrictions generally applicable to a qualified plan. The concern has been addressed. Nothing more is needed.

Imposing a limit on the amount that an annuity policyholder can invest on a tax-deferred basis also fails to recognize the flexibility that such a contract can offer. While vehicles such as Individual Retirement Accounts, which do have contribution limitations, offer an important supplement to personal savings for retirement, they do not, nor can they, meet every individual's needs. For example, many middle-income individuals are not able financially to set aside $2,000 each year early in their careers. As a result, the funds that they ultimately could contribute to an IRA beginning at age 45 or 50, will not provide sufficient retirement income. That person could, however, purchase an annuity contract and still be assured that he or she will have an adequate retirement income. However, a limitation placed on the amount that an individual can contribute on a tax-deferred basis would unfairly penalize the annuity purchaser vis-a-vis the individual who was able to make annual contributions to an IRA, receive a deduction for such contributions, and defer taxes on the interest earned on each dollar set aside.

Such a proposal also fails to take into consideration the case of a participant in an employer-sponsored pension plan, who leaves his or her place of employment prior to retirement. In many instances, the individual chooses to rollover these monies, in one single payment, into a nonqualified deferred annuity. Imposition of a dollar cap would serve only to discourage the individual from continuing to save for his or her retirement, particularly when the amount rolled over exceeded the limitation. Surely, this is not what Congress intends.

More fundamentally, if limiting the tax deferral is the reason behind the proposal, the suggested remedy is misplaced. The amount of tax-deferred income is as much (or more) a function of the rate of interest credited, and the period of time over which it is credited, as the aggregate premiums paid. Thus, limiting the premiums will leave different contractholders in different situations as to their tax deferral, depending on when they purchase their contracts, from whom, and what the prevailing interest rates have been and will be.

Finally, if a premium limit was imposed, the annuity value that it supposedly would allow to be purchased would be subject to erosion over time -- by the affects of inflation.

Americans have become increasingly concerned over their future financial security and the means by which they can provide for it. Although the Social Security system may provide a floor of protection, it never was intended to, and does not, provide for an individual's total retirement needs. The recent press coverage of the inability of our Nation's qualified pension plans to meet even the minimal retirement needs of a changing technological workforce is evidence enough of the important role which nonqualified annuities can and must play. Obviously if individuals are to provide for financial security in their later years, they must supplement their Social Security and their pension plans with personal savings. The annuity product is uniquely suitable for providing such supplemental income. Congress should continue to encourage savings through such socially desirable products.

The Joint Committee on Taxation's "Description of Possible Options to Increase Revenues," also offers a discussion of the alternative minimum tax ("AMT") and suggests that additional preference items could be added for AMT purposes. The inside build-up on annuity contracts is mentioned as a possible addition.

The theory behind the AMT is that all taxpayers who have current economic income should pay some tax currently on that income. Present law contains certain provisions that operate, for regular-tax purposes, as incentives by permitting acceleration of deductions or exclusions from income. Under the alternative minimum tax, individuals who use these so-called "preference items" for regular tax purposes are required to add them back to income for purposes of determining whether the individual has AMT liability. In other words, the AMT is intended to ensure that no taxpayer with substantial economic income can avoid tax liability by using exclusions, deductions, and credits.

While the perception that high-income taxpayers may be able to avoid taxes because of the number of preference items in present law may justify the inclusion of such benefits in the alternative minimum tax, such a justification does not exist in the case of the inside build-up on an annuity contract. First of all, the purchase of an annuity contract does not permit a taxpayer to decrease the amount of taxes on his or her current economic income. No favorable benefit is derived because taxes already have been paid on the dollars used to purchase the contract. Nor is it reasonable to consider the limited deferral on such annuities as a method by which individuals can avoid paying their fair share of taxes. As discussed previously, the owners of annuity contracts have not constructively received the increase in the value of their contracts, and their rights to receive these amounts are subject to substantial restrictions. Moreover, when annuity payments commence the investment income is taxed at ordinary income rates.

Furthermore, such a proposal adds substantial complexity to the law. We submit that the minimal amount of revenue -- if any -- that might be raised by including the inside build-up on annuity contracts as a preference item under the AMT does not outweigh the additional burdens and complications that such a provision would add to the tax laws.

The Committee of Annuity Insurers urges the Committee on Finance to reject any proposals that would alter the tax treatment of the inside build-up on annuity contracts. The current tax treatment of deferred annuity contracts is grounded in sound tax and social policy. A policyholder should not be taxed currently on income he or she has not received. As a matter of social policy, the reasons for the traditional taxation of annuities have not diminished. In fact, today more than ever, we as a nation need to encourage individuals to provide for their own security in their retirement years. For many, the annuity provides the only source of retirement income outside of social security. The proposals on nonqualified annuities put forth in the option pamphlet are unsound tax policy and even more importantly unsound retirement policy. As such, we respectfully request that they not be included in any reconciliation legislation reported from your Committee.

## COMMITTEE OF ANNUITY INSURERS MEMBER COMPANIES

Aetna Life & Casualty Insurance Company
Allstate Life Insurance Company
American Express Company
American General Life Insurance
American International Group
Anchor National Life Insurance
Capital Holding Corporation
Church Life Insurance Corporation
CIGNA Insurance Companies
Equitable Life Assurance Society of the United States
Family Life Insurance Company
Guardian Life Insurance Company of America
Hartford Life Insurance Company
IDS Life Insurance Company
Integrated Resources Life Companies
Kemper Investors Life Insurance Company
Life Insurance Company of the Southwest
Metropolitan Life Security Insurance Companies
Nationwide Life Insurance Companies
New England Mutual Life Insurance Company
New York Life Insurance Company
Reliance Life Companies
Sun Life of Canada
The Manufacturers Life Insurance Company
The Travelers Insurance Companies

August, 1987

## COMMENTS BY
## RICHARD B. DIXON
## CHIEF ADMINISTRATIVE OFFICER
## COUNTY OF LOS ANGELES

The possible options to increase revenues now being considered by the Committee on Finance of the United States Senate represent difficult choices to be made in what is an extremely difficult decade for government financing. It takes political courage even to suggest revenue increases to help cure the federal deficit problem. However, in considering options to raise additional revenues, the Committee must be mindful of the consequences to state and local governments.

We in state and local government have a historic partnership with the federal government in financing and providing a multitude of services. Revenue-raising options which impose indirect and direct taxes on us jeopardize this partnership and, more importantly, the provision of these services.

The County of Los Angeles faces severe budget cutbacks because of our open-ended, caseload-driven services (often mandated by the federal and state government) coupled with an inadequate financing base, including the recent loss of General Revenue Sharing monies. Several of the revenue-raising options under consideration would exacerbate our budget problems. They also would violate a long-standing principle of intergovernmental fiscal comity.

We would like to present the following comments on the revenue-raising options which will have an adverse effect on Los Angeles County.

1. **Mandatory Medicare Coverage for All Public Employees**

Under current law all public employees hired after March 1, 1986 are covered by Medicare. The current Medicare cost for Los Angeles County is $2.2 million (with an equal amount paid by covered employees). Medicare coverage for all current County employees would cost us an additional $27.3 million per year (with the same cost increase borne by our employees).

This proposal is contrary to the compromise agreed upon by Congress last year to phase in Medicare through new hires. It would result in immediate budget cuts for the County because we have no alternative means of financing an expenditure of this magnitude.

2. **Tax Exempt Bond Interest as a Preference Item in the Alternative Minimum Tax**

The Tax Reform Act of 1986 made interest on certain "private activity" municipal bonds subject to the alternative minimum tax. This has increased the County's cost of short-term borrowing for "private activity" purposes by about 35 basis points. The County expects to borrow approximately $785 million in the short-term market this year. If all tax-exempt interest were to be treated as a preference item in the alternative minimum tax, the County's cost of short-term borrowing alone would increase by $2.7 million per year.

Simply put, this proposal will increase our interest costs in borrowing for legitimate government purposes for what will probably result in a negligible increase in federal tax revenues. This proposal is another tax on state and local governments which is in violation of intergovernmental fiscal comity.

3. Repeal of Highway Excise Tax Exemption for State and Local Governments

This proposal would increase Los Angeles County's costs by approximately $1 million per year (assuming no increase in the excise tax rate). This will have an immediate and direct adverse impact on our ability to finance services. Most of our County fleet consists of law enforcement vehicles, fire engines, and other specialized vehicles which provide important governmental services. We fail to see why these essential governmental functions should be taxed by the federal government. This proposal represents a direct and inequitable tax on state and local governments.

4. Employee Benefits

Several of the options will increase the tax liability of the employee benefit components paid by the County of Los Angeles. The specific options involve limiting the exclusion from taxation of employer-provided health coverage, group life insurance, flexible benefit plans, and dependent care reimbursement accounts. Our concern is twofold: (1) the recruitment and retention of skilled employees; and (2) the future cost of these benefits to maintain the employees' current compensation package.

In response to cost shifts and limited available financing, Los Angeles County has reduced the cost of our employee compensation packages and increased employees' take-home pay by utilizing federal tax law. We do not have the financial capability to deliver equivalent compensation packages under these proposed tax law changes. Further limitations on the design of our compensation packages would result either in service reductions (because of cost increases) or in a reduced capacity to recruit and retain employees because of inadequate total compensation. An example of the latter is the value of having a cadre of highly qualified District Attorney prosecution staff who can take on major felony cases, such as drug dealing, where the dollars available for the defense are virtually unlimited. Over the past decade, we have been able to retain this experienced group of attorneys due in large part to our overall compensation package. A change in federal tax law regarding the taxability of employee benefits could result in a substantial reduction in services, including the loss of these attorneys.

5. Disallowance of Deduction for Nonbusiness Personal Property Taxes

Personal property taxes are an important local revenue source for counties in California. In the past, Los Angeles County has supported state legislation to revise vehicle depreciation schedules to increase the personal property taxes associated with this tax base. We believe that further depreciation revisions can be justified based upon market values of used vehicles. A change in federal tax policy to disallow deductions for personal property taxes would disrupt such efforts and, in effect, would impose federal control over a local tax base. Federal vehicles, of course, are exempted from this tax base.

## Background on Los Angeles County

In California, counties are a multiservice form of government. The 58 counties in California are responsible for a wide range of local, regional, and human services. For example, counties in California are the local agencies responsible under State law for providing health, welfare, justice, and other key regional services to all the residents of the county. Counties also provide municipal services to unincorporated areas. In Los Angeles County, this includes over one million people in rural, wilderness, suburban, and urban areas of the County. Our County also provides a wide range of municipal services, including police, fire, and library services, to many of the 84 cities in the County.

In Los Angeles County, all of these functions are performed on a giant scale. Los Angeles County has a total population of eight million residents, which is about 31 percent of California's population, spread over more than 4,000 square miles. We are the most populous County in the nation -- in fact, our population is larger than 42 of the 50 States.

Here are just some of the programs that Los Angeles County operates:

- seven hospitals, 45 health centers, three comprehensive health centers, and two alcoholic rehabilitation centers;
- the largest system of local jail facilities in the United States, with currently about 23,000 inmates;
- twenty-four municipal courts, 21 superior court locations, and one justice court. Our superior court is the largest court of original jurisdiction in the United States, and our District Attorney is the largest prosecutorial agency, with over 2,000 employees.

We also conduct elections and operate libraries, small craft harbors, the Los Angeles Music Center, the Hollywood Bowl, almost 100 parks, ten beaches, two museums, and three botanical gardens.

In other words, County government has a major impact on the health, safety, and well-being of everyone in the County.

By many measures, the Los Angeles area is in good economic shape in comparison with other areas in the nation. Many of the nation's leading manufacturing and financial institutions are centered in Los Angeles, and there is an increasing flow of international investment and trade.

But there is also a downside to the Los Angeles economic picture. With 30.7 percent of the State's population, the County also has:

-- thirty-eight percent of the State's Aid to Families with Dependent Children (AFDC) population (620,000 recipients);
-- fifty-two percent of the State's General Relief Population (over 40,000 recipients);
-- forty-five percent of the State's violent crime;
-- forty-six percent of the State's drug arrests;
-- forty percent of the State's felony arrests;
-- the largest homeless population in the country; and
-- according to the 1980 census, our County has 32 percent of the illegal aliens in the nation.

We are in serious and chronic fiscal trouble in Los Angeles County. The basic problem is that County government does not benefit from the upside of the economy -- the increased sales and income tax revenue derived from economic prosperity -- but County government is mandated to pay for the downside -- the indigent health, human services, general relief, jails, and justice system costs. These programs are caseload-driven, rapidly growing, and must be funded.

The open-ended costs include health care and general relief to the indigent, AFDC, courts and related programs such as prosecution and indigent defense, and jails and juvenile detention.

In Los Angeles County, the costs for responding to these needs now consume 56 percent of our County's so-called discretionary revenues -- such as property and sales tax revenues. Only 44 percent of our discretionary revenues are available today to fund critical local programs, such as the sheriff's department, fire protection, and recreation, culture, and other government services.

Moreover, health, welfare, and justice costs are growing at a faster rate than the revenues available to the County to pay for them. In Los Angeles County, local costs for welfare have increased by 158 percent since 1980. Health and mental health costs have increased by 83 percent. Jail and detention costs have increased by 157 percent. However, the local revenues available to fund these mandates have increased by only 78 percent.

Why doesn't the County's revenue keep up with its costs? There are three reasons.

The first reason is that the County's principal revenue source, the property tax, is limited by the State constitution in both its base and growth, and has been eroded by Community Redevelopment Agencies which now siphon off $100 million per year in property taxes from the County General Fund and special districts. The second reason is that other major revenue sources, such as the sales tax, are only minimally available in Los Angeles County because most areas in the County that generate sales tax are incorporated or are quickly annexed. Among California counties, Los Angeles County has the second lowest per capita sales tax revenue in the State. The third reason is that counties have no independent revenue source. Unlike cities, counties cannot impose taxes or charges in excess of costs. Essentially, counties have a fixed revenue base and must trim property-related services to fit whatever revenue is left after State-mandated services have been provided.

In January 1987, we projected a potential $170 million deficit in our 1987-88 budget. (Continuation of General Revenue Sharing would have eliminated almost one-half of this deficit.) Because the County is required by State law to have a balanced budget, this potential deficit had to be eliminated. We were able to erase some of the potential deficit through productivity savings, contracting out of services, fee increases, additional state assistance, and other initiatives, but it was still necessary to cut programs by $33.7 million to live within our resources. In addition, our adopted budget does not include an urgently needed $20 million for maintaining the Los Angeles County Trauma Center Network.

## Conclusion

Certain problems are beyond the capacity of local government to solve. International unrest and third world conditions can result in a county government being inundated with needy refugees and immigrants who need health, welfare and housing. National and global economic factors can result in the elimination of a local area's economic base, leaving its residents both in need of services and unable to contribute to the tax base. In urbanized counties such as Los Angeles, there has been an influx of the homeless and the mentally ill from throughout the country, which has placed special strains on our limited resources. These kinds of problems are national in character and beyond the fiscal scope of local communities.

We firmly believe that the fiscal integrity of state and local governments must be respected in whatever final mix of revenue-raising options you adopt. We cannot continue to provide services absent both direct federal subventions and a federal tax policy which is neutral towards our current finances.

Thank you for this opportunity to provide comments.

## Statement on Behalf of
## COALITION ON HUMAN NEEDS

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**Susan Rees**
**Executive Director**
**Coalition on Human Needs**

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Mr. Chairman and Members of the Committee:

My name is Susan Rees and I am executive director of the Coalition on Human Needs, a non-profit organization which represents the poor, minorities, women, children and the disabled. We stand for the idea that ultimately the federal government is responsible for seeing that basic human needs are met.

A major component of the Coalition's approach to solving social problems is its support for a fair, progressive tax system. This does not mean that we favor a system of minimal taxation, because only by raising sufficient revenues can we ensure that we provide for the basic needs of our society. Rather, we favor a system that exempts the poor and taxes according to ability to pay. No flat tax, including excise taxes unless they are on luxury goods, can meet this standard.

That is why we wholeheartedly oppose the proposed increases in consumption taxes on ordinary consumer goods. If there is any tax that is more unfair to the poor than an excise tax, I would hope that Congress never discovers it.

Let's assume that Congress raises the excise tax by the following amounts: 12¢ a gallon on gasoline; 49¢ a sixpack for beer; 32¢ on a pack of cigarettes; and by maintaining the current 3% tax on local telephone services. According to the Congressional Budget Office study released in January, this package would cost families earning less than $10,000 a year more than 2 1/2% of their incomes -- more than twice the tax cut the poor received from last year's reform act.

The less a family makes, the less they spend on items like gasoline, beer, cigarettes, and telephone. But the percentage of a poor family's income spent on these items is many times what it is for an upper-middle class or wealthy family. When a poor family spends $900 a year on gasoline, that's 6% of its earnings. When a wealthy family spends $1,800 a year on gas, that's less than three-tenths of a percent of its income. And the disparate percentages are even greater for tobacco, alcohol and telephone services.

The Coalition is wholeheartedly in favor of increasing tax revenue by the $19 billion needed -- or even more. What we do support is further progress toward making the tax system more equitable, by eliminating the loopholes and percentages favoring the rich which were left in last year's tax bill.

For example, the tax bracket for the nation's wealthiest families -- those earning over $200,000 a year -- is scheduled to fall from 38.5% to 28%. Left at the higher rate, this change would bring in $3 billion more than the minimum needed to meet this year's revenue goals. Expensive restaurants are not suffering from the new restriction on business meals to 80%; lowering the deduction to 50% would raise more than $6 billion in revenue while making progress on a basic fairness issue. Both these measures stem from the same moral notion, that you don't raise taxes on those who can barely afford to eat so that the wealthy can enjoy more on their table.

But even more to the point is eliminating the corporate loopholes that were lobbied into last year's tax act. The rush to Master Limited Partnerships and substituting debt instruments for stock by dozens of corporations demonstrates that all doors to tax avoidance must be closed to ensure that America's wealthiest entities pay their fair share of tax. Defense contractors are still using "completed-contract" accounting; wealthy investors who wouldn't know a longhorn from a buffalo are still profiting from tax-shelter farming. And the provisions which allow foreign investors to avoid withholding on investments, and which permit tax deferrals on runaway plants, are costing us billions in revenue and hurting working people as well. The coalition recently completed a study where we found a new class of poor people created by tax-subsidized bankruptcies and plant shutdowns by profitable companies.

We are not naive. We know that closing these loopholes which benefit only the richest will subject this Committee's members to the same frantic lobbying from well-financed special interest groups as you experienced last year. We know the Reagan Administration has not yet gained fame as a proponent of progressive taxation. But we also know that last year this Committee set a standard for fairness and for attention to the general public's welfare that influenced the House, the Senate and the Administration to make great progress towards more equitable taxation. We ask you to recommit yourselves to that standard, and to deny any proposed increases in excise taxes.

Thank you.

Submitted August 14, 1987

# STATEMENT OF THE COMMITTEE OF LIFE INSURERS TO THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE CONCERNING OPTIONS TO RAISE REVENUES

The Committee of Life Insurers appreciates the opportunity to submit this statement to the Committee on Finance on the possible options to raise revenues with respect to life insurance contracts presented in the Description of Possible Options to Increase Revenues (JCS-17-87), June 25, 1987 (the "Description of Possible Options").

The Committee of Life Insurers is an ad hoc group of 23 life insurance companies which sell a wide variety of life and health insurance products, including single premium life insurance policies. The Committee was organized to monitor tax legislative developments affecting life insurance contracts, and single premium life insurance contracts in particular, and to convey the views of the member companies to the Congress. A list of the companies which comprise the Committee of Life Insurers is appended to this statement.

## I. Introduction

The Description of Possible Options lists (at pages 223 - 224) the following possible changes with respect to the Federal income tax treatment of life insurance contracts:

1. Include the inside buildup of newly-issued life insurance policies in the income of the policyholder.

   Alternatively, include the inside buildup of newly-issued life insurance policies in income only in the case of policies held by persons other than natural persons, e.g., corporations.

2. Modify the definition of life insurance "to provide that significantly investment-oriented life insurance policies such as single-premium life insurance policies would not be treated as life insurance policies for Federal income tax purposes . . . . For example, if the amount of the premium in any year substantially exceeds the amount needed for level premium funding of the death benefit, or the income earned on the contract is from high-risk or high-return investments, then the contract would not be treated as life insurance."

   "Alternatively, only the excess investment income could be taxed currently with respect to newly issued policies."

3. In the case of newly issued life insurance policies, distributions prior to the death of the insured would be treated as coming first from the inside buildup of the policy, i.e., taxed on an income first basis.

4. In the case of new loans under life insurance policies, the loans would be treated as distributions under the policy.

5. "Low or no net interest policyholder loans could be treated as below-market loans and the foregone interest on the loans could be treated as a distribution of income on the contract to the policyholder."

The American Council of Life Insurance and the Health Insurance Association of America have submitted a joint statement (the "ACLI Statement") urging the Committee on Ways and Means not to adopt any of these possible options. We agree with the ACLI Statement and endorse the view that adoption of any of these changes in the treatment of life insurance contracts would be unsound. As the ACLI Statement points out, in the last several years Congress has thoroughly considered the Federal income tax treatment of life insurance contracts. This extensive review resulted in the enactment in 1984 of a Federal tax definition of a life insurance contract and an amendment in 1986 to that definition which altered the traditional treatment of distributions under life insurance contracts. Furthermore, just last year Congress expressly rejected the President's proposal to tax the inside buildup of life insurance contracts.

Taken together, these decisions reflect a considered judgment of Congress that the current income tax treatment of life insurance policyholders is correct. There is no reason to re-examine these carefully crafted congressional decisions in the hurried context of budget reconciliation, especially when very little revenue would be raised by any of the life insurance contract options.

The Description of Possible Options includes, in addition to the proposals with respect to life insurance contracts in general, options with respect to single premium life insurance policies in particular. The ACLI Statement asks that the options with respect to single premium life insurance policies be rejected. Given the many issues which the ACLI must address in its statement, however, its discussion of single premium life insurance policies is necessarily brief.

We believe that the inclusion in the Description of Possible Options of options involving single premium life insurance policies may well have been caused by a misunderstanding of the nature and uses of single premium life insurance. We think it important that these misunderstandings be corrected. Moreover, we respectfully submit that if the true nature and uses of single premium life insurance policies were understood, the Committee would readily conclude that the treatment of such policies under the Internal Revenue Code is correct and that no changes should be made in that treatment. Accordingly, the remainder of our statement will be devoted to single premium life insurance contracts.

## II. What is Single Premium Life Insurance?

Some people seem to think that a single premium life insurance policy is a recently developed investment vehicle, the income tax treatment of which Congress has not adequately considered. They are wrong. The fact is that single premium life insurance is a traditional and important form of life insurance, the income tax treatment of which was thoroughly considered by Congress in 1984.

Single premium life insurance policies have been available in the United States since approximately 1900. Like all other life insurance policies, a single premium life insurance policy provides a death benefit substantially greater than the premium paid for the policy, thereby protecting the insured's beneficiary against financial loss from premature death. In addition, the death benefit relative to the policy's premium or cash value is regulated by section 7702 of the Internal Revenue Code, the provision which Congress enacted in 1984 to set forth the tax definition of life insurance.

As its name suggests, the feature which distinguishes a single premium life insurance policy from any other type of permanent life insurance policy is that it is purchased with one premium payment, rather than a series of premium payments extending over a period of years. Aside from the mode of premium payment, however, a single premium life insurance policy is essentially identical to any other form of permanent life insurance contract. Thus, first and foremost, a single premium life insurance policy guarantees that the insured's beneficiary will receive a substantial death benefit whenever the insured dies.

In addition, like all other permanent life insurance contracts, a single premium life insurance policy has a cash surrender value which is mandated by a uniform law, known as the Standard Nonforfeiture Law, which is in effect in all states. In addition to requiring that permanent life insurance policies provide a cash surrender value, the Standard Nonforfeiture Law requires that a policyholder who discontinues making premium payments have the option to use the contract's cash value as a single premium to purchase a paid-up life insurance policy in a lower amount. That is to say, pursuant to uniform state law all permanent life insurance policies may be converted at the policyholder's option into a single premium life insurance policy.

This is not surprising. If the expenses associated with the sale and administration (the "loading") of a life insurance policy are set aside, all forms of permanent life insurance policies are essentially the equivalent on a present value basis of a single premium life insurance policy. Whether an individual purchases a limited pay life insurance contract with level annual premiums payable for a fixed number of years, an ordinary life insurance contract with level annual premiums payable for life, or a universal life insurance contract with flexible premium payments, the present value of the net premium payments (the premiums without loading) for a given amount of death benefit is equal to the net single premium (the single premium without loading) under a single premium life insurance policy providing the same amount of death benefit.

Single premium life insurance policies, like all other permanent life insurance policies, also have a policy loan provision mandated by state law. The policy loan provision usually provides that the life insurance company will lend the policyowner an amount up to the cash surrender value of the policy, that the company can charge interest on that loan at a specified rate (which is limited by state law but may vary in accordance with a formula or an index), and that the policyowner may repay the loan in whole or in part at any time. If, however, the policyowner has not repaid the loan at the time the insured dies, the amount of the death benefit proceeds payable to the insured's beneficiary will be reduced by the amount of the outstanding loan and any unpaid interest.

In sum, single premium life insurance policies generally differ from other forms of permanent life insurance only in that they are purchased with one premium payment. As discussed in the next section of our statement, this difference can be quite beneficial to a purchaser.

## III. For What Purposes are Single Premium Life Insurance Policies Purchased?

Single premium life insurance policies are purchased for the same reasons as other forms of permanent life insurance, including the guarantee of lifetime insurance protection combined with long term savings. These reasons have traditionally been recognized as worthy goals deserving of encouragement, not abuses to be discouraged. Indeed, the Description of Possible Options acknowledges this and states (at page 226) both that "[e]ncouraging people with disposable income to provide financially for their dependents in the event of death is an important social policy that should be encouraged . . ." and that "[w]hole life insurance . . . provide[s] a vehicle by which individuals who do not participate in a qualified pension plan may fund adequate amounts of future retirement income and security for their dependents on a tax-favored basis."

The single premium payment method offers particular advantages to purchasers. For example, if an individual aged 45 were to purchase a single premium life insurance policy with a death benefit of $100,000, the single premium paid for the policy would be substantially less than the sum of the 50 annual premiums the same individual would pay for a whole life insurance contract also with a death benefit of $100,000. Indeed, for any given amount of death benefit, the total cost of a permanent life insurance policy will increase as the number of required premiums increases and as the duration over which the premiums are paid lengthens.

Obviously, much of this increased cost is attributable to the fact that in the case of the whole life insurance contract the individual has the benefit of the use of his money prior to each premium payment. The fact remains, however, that purchase of a single premium policy rather than a policy with annual premiums payable for a lengthy period is analogous to making a cash purchase rather than an installment purchase -- the purchaser pays a smaller amount for his or her purchase.

Another advantage of purchasing a permanent life insurance policy with a single premium is that the owner obtains guaranteed permanent (or whole) life insurance protection in a fixed amount without the necessity of any further premium payments. In contrast, if a permanent life insurance policy is purchased on other than a single premium basis, the policy will lapse if future premiums are not paid. (In that event, if the policy has any cash value, the cash value will be applied either to purchase a single premium paid-up policy in a lower amount or to purchase a single premium term policy for a period shorter than the whole of life.)

Like all other forms of permanent life insurance, a single premium life insurance policy provides a savings element through the annual increments to the policy's cash surrender value. The presence of this mandatory savings feature has traditionally been one of the reasons that individuals purchase permanent life insurance rather than term life insurance, and historically it is one of the reasons that some persons have purchased single premium life insurance policies. For example, older individuals are often purchasers of single premium life insurance policies. For such individuals, a single premium life insurance policy offers substantial income protection and estate liquidity from a single purchase payment. In addition, an older person seeking life insurance protection will find level premium or increasing premium coverage to be much more expensive in the long run -- perhaps prohibitively so -- whereas single premium based coverage will present itself as affordably priced.

Nevertheless, the purchaser of a single premium life insurance contract, like the purchaser of any other life insurance contract, obtains a substantial death benefit and must incur mortality charges for this insurance benefit. As a consequence, the earnings on the savings element of a permanent life insurance contract are necessarily reduced by the mortality costs assessed by the insurance company. In addition, an applicant for a single premium life insurance policy must establish that he or she is insurable. No life insurance company will issue a single premium life insurance policy without requiring the applicant to furnish medical information (either by answering a medical questionnaire or by taking a medical examination) and without establishing that the beneficiary has an insurable interest in the insured. Virtually all life insurance companies then verify the applicant's medical history with the Medical Information Bureau.

The consequence of the interrelationship of the death benefit and the savings element of a single premium life insurance policy is that, however beneficial the savings element might appear to an applicant, it is unlikely that a single premium life insurance policy will be purchased by an individual who does not find worthwhile the substantial costs of a large amount of life insurance protection.

## IV. Is Single Premium Life Insurance Too "Investment Oriented?"

The Description of Possible Options raises the question whether single premium life insurance policies are too "investment oriented." Congress answered this question with a "no" just three years ago and in effect reaffirmed that answer last year. A review of that experience is nevertheless worthwhile. In 1983 and 1984, Congress intensively studied the Federal income tax treatment of life insurance contracts. That study arose from concerns that some life insurance products were overly investment oriented -- in that they contained large cash values relative to the amount of insurance protection -- and that the traditional use of life insurance as financial protection against premature death was being overshadowed by its use as a tax-favored investment. The congressional study culminated in the enactment of section 7702, the Federal tax definition of a life insurance contract.

### A. Section 7702

Section 7702 contains two alternative tests by means of which a contract can qualify as a life insurance contract for Federal tax purposes: (1) a cash value accumulation test, and (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. The cash value accumulation test was designed to allow traditional whole life insurance contracts "with cash values that accumulate at reasonable interest rates" to qualify as life insurance contracts. Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, p. 647 (1984) (the "General Explanation").

The guideline premium requirement of the second test "distinguishes between contracts where the policyholder makes traditional levels of investment through premiums and those which involve greater investments by the policyholder," while the cash value corridor requirement "disqualifies contracts which allow excessive amounts of cash value to build up . . . relative to the life insurance risk." General Explanation, pp. 649-50. The cash value corridor requirement thus assures that if a life insurance contract develops a higher cash value than the life insurance company guaranteed at the time the contract was issued (because of higher interest being credited to the policy's cash value, for example), the policy's death benefit will increase. The General Explanation concludes that together "these requirements are intended to limit the definition of life insurance to contracts which require only relatively modest investment and permit relatively modest investment returns." Id.

In developing these definitional tests, Congress specifically reviewed the investment orientation of a number of life insurance products. Some products which traditionally had been sold by life insurance companies, such as endowment contracts, were determined to be too investment oriented and thus were excluded from the tax definition of a life insurance contract. Single premium life insurance contracts were carefully considered in this review.

Given that a permanent life insurance policy's cash value is a byproduct of the advance payment of the cost of insurance, a life insurance policy which is purchased with a single premium will have a higher cash value than one which is purchased with premiums payable for the whole of life. That is not to say, however, that such a policy is too "investment oriented." To the contrary, after extensive consideration, the Select Revenue Measures Subcommittee of the Ways and Means Committee, which was developing the definition of life insurance, determined that the fact that a life insurance policy is purchased with a single premium does not in and of itself mean that the policy is too investment oriented. Thus, the Subcommittee, and ultimately the Congress, specifically concluded that single premium life insurance policies should continue to be treated as life insurance contracts for Federal tax purposes.

Although section 7702 therefore allows single premium life insurance policies to qualify as life insurance contracts, that section imposes strong constraints against the use of such policies as investments rather than to provide life insurance protection. One example of this is that the guideline premium test imposes a stricter assumption with respect to the interest rate used to calculate the guideline single premium (6 percent) than it does for the calculation of the guideline level premium (4 percent). The effect of this stricter interest assumption is to reduce the amount of the premium which could otherwise be paid for a given amount of death benefit. Another example is that, in making the single premium determinations under either of the two definitional tests, it must be assumed that the policy's death benefit does not increase; in contrast, certain increasing benefit patterns may be reflected in determining level premiums. This rule was specifically intended to limit the investment orientation of a single premium life insurance policy, and its effect also is to reduce the amount of the allowable single premium payment.

## B. Surrenders and Loans

The Tax Reform Act of 1986 amended section 7702 to limit further the possible use of life insurance contracts in general, and single premium life insurance contracts in particular, as investments. Traditionally, amounts received under a life insurance contract as a result of partial withdrawals or surrenders of the contract have been taxed only after the policyowner has recovered his investment in the contract. That is, such amounts constitute first a withdrawal of the policyowner's investment in the contract, and then a withdrawal of any gain in the contract.

As part of the 1986 tax reform process, Congress reviewed the distribution rules for life insurance contracts. Some members of Congress and representatives of the Treasury believed that application of the traditional rule was inappropriate in circumstances where a life insurance contract had a cash value that was the maximum, or close to the maximum, allowed by section 7702. As a result, section 7702 has been amended to provide that if, during the first fifteen years after a life insurance contract is issued, there is a reduction in the death benefit and amounts are withdrawn from the policy, then in specified circumstances "a portion of the cash distributed to the policyholder . . . will be treated as being paid first out of income in the contract, rather than as a return of the policyholder's investment in the contract . . . ." Joint Committee on Taxation, Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation, p. 107 (1987).

This rule affects single premium life insurance policies in particular and generally prevents a policyowner from making a substantial partial withdrawal of cash values free of tax during the first 15 years after the policy is purchased. For example, consider an individual aged 45 who purchases a single premium life insurance contract with a death benefit of $75,000 and pays a premium of $18,480, which is the maximum premium section 7702 allows for that particular contract. If two years later, when the policy's cash value is $21,356, the individual partially surrenders his contract and reduces the death benefit to $65,000, while receiving $2,680 of the policy's cash surrender value, all of that amount will be included in the individual's income under the 1986 amendment to section 7702.

The ability of a policyowner to withdraw the cash value of his single premium life insurance policy is constrained not only by the 1986 amendment of section 7702, but also by the design features of such policies. Single premium life insurance policies (like other non-term life insurance policies) are intended by insurers to be permanent life insurance contracts. In order for the insurer to make a profit on such contracts, the contracts must remain in force and the cash value of the contacts must remain with the insurer for a substantial period of time. Thus, almost all single premium life insurance contracts impose a substantial surrender charge if the policyowner surrenders the contract within seven years of purchase, and many impose such charges if the surrender occurs within ten years.

Policyowners do, of course, have a state law mandated right to borrow some or all of the cash value of a life insurance contract. Nevertheless, like most other permanent life insurance contracts, single premium life insurance policies contain disincentives to borrowing. For example, if a policyowner borrows amounts from the policy's cash value, the rate of interest being credited to the cash value is frequently reduced. In addition, interest paid on policy loans under single premium life insurance policies has not been deductible for many decades. Most importantly, if a policyholder does not repay a loan, the death benefit proceeds payable to the insured's beneficiary will be reduced by the outstanding amount of the loan and any unpaid interest on the loan.

In sum, not only are single premium life insurance policies not too "investment oriented," but Congress itself recently has made this determination.

## V. Conclusion

We recognize that the Committee on Finance has a very difficult task to perform in a very short time. Under the terms of the fiscal year 1988 Budget Resolution the Committee must meet a revenue reconciliation target of $19.3 billion for the fiscal year 1988 and $64.3 billion for the fiscal years 1988 through 1990. In addition, the Committee must report a bill which reaches these goals by September 29. Moreover, all this must be accomplished less than one year after Congress enacted the Tax Reform Act of 1986, a comprehensive act which closed many obvious "loopholes" and potential sources of tax revenue.

These goals and the short time frame within which they must be met nevertheless suggest additional reasons why the Finance Committee should not consider any changes in the Federal income tax treatment of life insurance contracts, including single premium life insurance policies. The Federal tax definition of a life insurance contract set forth in section 7702 is extremely complex. The statute was carefully crafted and embodies a number of interrelated provisions intended to accommodate both the policy concerns of Congress and the design of various types of permanent life insurance contracts, including both traditional fixed premium contracts and universal life insurance contracts. Development of this statute took place over a three year period and required extensive participation by the Treasury Department, the congressional tax committees and their professional staffs, and many actuaries and other representatives of the life insurance industry.

In view of the complexity of the tax definition of a life insurance contract, and the importance to so many policyholders that the definition work properly, it would seem ill advised to attempt to modify section 7702 in the midst of the necessarily rushed budget reconciliation process unless there was some pressing need to do so. The facts are, however, that no such need exists.

When it enacted section 7702, Congress anticipated that it would wish to review the operation of that provision. Congress therefore directed the Treasury Department to conduct an analysis of life insurance contracts and their taxation. That report is due to be submitted to the Committee on Finance on January 1, 1989, approximately eighteen months from now. We respectfully submit that that will be the appropriate time, when the relevant facts have been assembled and all concerned have had an opportunity to analyze those facts, to consider whether any changes in the income tax treatment of life insurance contracts should be made.

In addition, it seems highly unlikely that changes in section 7702 would raise any revenue; if the definition of a life insurance contract were to be modified to tax the inside buildup of a certain type of contract, that type of contract would no longer be sold. In any event, even if the estimated revenue effect of such an option were to prove correct, the revenue thus gained is small relative to the potential disruption in the treatment of a product providing valuable benefits to many people. Such a change seems especially unwarranted when, as discussed above, there is no tax policy reason to make any charges -- let alone any immediate changes -- in the tax treatment of single premium life insurance policies.

In conclusion, single premium life insurance policies, despite the impressions to the contrary that some may have had, are traditional life insurance policies and should continue to be treated in the same manner as all other life insurance contracts for tax purposes. Certainly, no changes should be considered during the budget reconciliation process.

Committee of Life Insurers

Charter National Life Insurance Company

Connecticut National Life Insurance Company

Executive Life Insurance Company

Family Life Insurance Company

Fidelity Bankers Life Insurance Company

First Colony Life Insurance Company

Guardian Insurance and Annuity Company, Incorporated

IDS Life Insurance Company

Integrated Resources Life Companies

Jackson National Life Insurance Company

Kemper Investors Life Insurance Company

Keystone Provident Life Insurance Company

The Midland Mutual Life Insurance Company

National Home Life Assurance Company

National Western Life Insurance Company

Nationwide Life Insurance Company

North American Company for Life and Health Insurance

North American Security Life Insurance Company

Pacific Mutual Life Insurance Company

Provident Mutual Life Insurance Company of Philadelphia

Sun Life Assurance Company of Canada

United Pacific Life Insurance Company

Xerox Financial Services Life Insurance Company

# STATEMENT
# OF
# GEORGE HAEFNER
# PRESIDENT, CONAGRA POULTRY COMPANY
# AND
# ELBERT L. THOMAS, JR.
# VICE PRESIDENT, THE FEDERAL COMPANY

Thank you Mr. Chairman.

My name is George Haefner. I am President of ConAgra Poultry Company. Joining me today, and available to answer any questions you may have, is Mr. Eb Thomas, Vice President of The Federal Company.

We are here to express our support for proposal 7(a) on page 154 of the hearing pamphlet which would raise hundreds of millions of dollars by requiring a few large food processors that currently use the cash method of accounting to use the accrual method. Under the cash method, these food processors deduct expenses in advance of the time the income attributable to the expenses is earned or received. This difference in the timing of income and expense enables these companies to save hundreds of millions of dollars a year in taxes.

Under a provision added to the Code by the 76 Reform Act, farming corporations are required to use the accrual method if their annual revenues exceed $1 million. An exception to this rule is provided for family farms that generally are too small and too remote to have access to the sophisticated assistance required to use the accrual method. The large food processors that would be affected by the proposals being considered by you today are currently being treated as family farms under this exception. They are the only large corporations in any industry that are still permitted to use the cash method.

Two brief excerpts from the House Report to the 76 Reform Act provide insight into the origins of the family farm exception.

> The opportunity for farmers generally to use the cash method of accounting . . . was granted over 50 years ago by administrative rulings. These rulings were issued at a time when most agricultural operations were small operations carried on by individuals. The primary justification for the cash method of accounting for farm operations was its relative simplicity. . .

Two paragraphs later, after noting that in recent years "many corporations [had] entered farming," the House Report stated:

> [I]t is appropriate to require corporations . . . engaged in farming to use an accrual method of accounting . . . Your committee, however, has excepted from this requirement small or family corporations in order to continue the cash basis method essentially for all but the larger corporations engaged in farming. (Emphasis added)

The intent of the Congress was clear and, we believe, reasonable; require accrual accounting for farming corporations that, based on their size, could be expected to have the sophistication and resources required to use accrual accounting.

The problem arises with the definition of the term "family farming corporation." The term is defined solely by reference to the ownership of the entity and without regard to its size. Under this definition very large food processors, including publicly traded corporations with hundreds of millions of dollars of revenues each year, are permitted to use the cash method.

Mr. Chairman, under the proposals being considered today, small food processors and farming corporations would be permitted to continue using the cash method. However, the larger food processors would be denied the benefits of the family farm classification. For example, one of the proposals would deny these benefits only to food processors with annual revenues over $100 million. Clearly, no true family farms would be affected.

Mr. Chairman, we urge the Committee to act favorably on the proposals being considered today because it is unfair to all other taxpayers to allow these corporations to use special rules to reduce the amount of tax they must pay on the income they earn; it is unfair to other food processors, like ConAgra and The Federal Company, that compete with these corporations for capital, for research and development successes, and for market share.

Moreover, there is absolutely no social or economic reason for permitting large food processors to use the cash method. The only argument these corporations make in support of cash accounting is that they need the tax advantages to insulate themselves, and certain small farms that contract with them, from adverse market conditions. In other words, they argue that if they are required to pay their fair share, they will have less cash on hand to deal with hard times.

The response to this argument is clear. First, if ConAgra and The Federal Company can operate in the same environment without these tax benefits, the cash method food processors can also operate without these tax benefits. Second, any corporation in any business could make the same argument. If many did, and if the Congress listened, we would all be in a great deal of trouble.

Finally, Mr. Chairman, the cash method food processors do not need the tax benefits afforded by this loophole to protect the small farmers with whom they contract. The method of accounting employed by a billion dollar corporation simply does not have any effect on the persons that it may contract with or otherwise employ. The growers that contract with ConAgra and The Federal Company are not affected in any way by the methods of accounting used by our companies. I should also point out that under the proposals being considered by you today, all of these small farmers would themselves be permitted to remain on the cash method.

Last year the Congress enacted a true tax reform bill. That bill repealed tax subsidy provisions and closed loopholes left and right, including some that benefited large groups of businesses or consumers, or that supported positive social or economic objectives. In this light we urge the Committee to respond to this issue of fairness and close a loophole that has no social or economic justification, that benefits only a very narrow group of taxpayers, and, most importantly, that costs the federal government hundreds of millions of dollars every single year.

Thank you very much.

# A WRITTEN STATEMENT
# BY ELLEN F. COOKE
# TREASURER OF
# THE DOMESTIC AND FOREIGN MISSIONARY SOCIETY OF THE PROTESTANT EPISCOPAL CHURCH IN THE UNITED STATES OF AMERICA

I am Ellen F. Cooke, the Chief Financial Officer of The Domestic and Foreign Missionary Society of the Protestant Episcopal Church in the United States of America, The General Convention of the Episcopal Church, and The Executive Council. The Episcopal Church is comprised of 117 autonomous dioceses, 98 of which are domestic and 19 foreign. Each Episcopal Congregation is in canonical union with a specific diocese. The church's governing body is the General Convention which convenes every three years to determine the course of ongoing mission operations. These operations are carried out primarily by The Domestic and Foreign Missionary Society of the Protestant Episcopal Church in the U.S.A., Inc., (hereafter called 'The Society'.) The Society's Board of Directors is the Executive Council, members of which are elected by the General Convention and the Nine Provinces of the church. It is recognized by the Treasury Department as a 501(c)(3) tax-exempt religious organization.

This statement is prepared for submission to the Senate Finance Committee in connection with Committee hearings scheduled for July 15, 16 and 17, 1987 regarding the description of possible options to increase revenues prepared for the Senate Finance Committee by the staff of the Joint Committee on Taxation and the Ways and Means Committee in connection with Fiscal Year 1988 Budget Resolution. My comments deal with two of the possible options for increasing tax revenues in connection with the Fiscal Year 1988 Budget Resolution now being considered by the Ways and Means Committee:

(1) An excise tax on net investment income of churches;

(2) Repeal of the exclusion (from an individual's taxable income) of the employers' cost of providing health care coverage to employees.

Both of these revenue options would diminish the ability of our churches to fulfill their mission. To the extent that the mission of a Church can be perceived as divisible, its two major components are:

(1) Worship of God

(2) Service of humanity

The Congress would undoubtedly find it constitutionally impossible to interfere with the former and financially counterproductive to interfere with the latter. The Committee Staff Report clearly and fairly points out that the existing exemption recognizes that:

(a) '...many exempt organizations perform functions that lessen the burdens of government that otherwise would have to be financed out of tax revenues...'

(b) '...promote the general welfare of the public at large...'

(c) '...contribute to the economic well-being of the country through promotion of business and labor.'

(d) 'The imposition of the tax would reduce the funds available to and needed by charities, social welfare organizations, and other exempt organizations in carrying out their nonprofit activities. The tax thus would adversely affect the beneficiaries of these programs, including the poor, the elderly, students, hospital patients, the environment, etc.'

Of overriding importance to the churches with regard to each of these additional tax options is the fact that the resources of the churches would be diverted from its mission. It is of utmost importance that the Committee be informed of the extent to which these negative economic factors in (a) (b) (c) and (d) above have been reflected in the 'Estimated Revenue Effects' appearing in the pertinent sections of the Committee document now under consideration.

The facts are presented below and in Exhibit A, attached.

## Section II. F. 2.

## Excise Tax on Churches

Before the Committee votes to impose an excise tax on the net investment income of all tax exempt organizations, specifically including churches and church pension plans exempted from ERISA, it should consider these two facts:

(1) Many taxable organizations are not now paying income taxes on all of their net investment income. Please see Exhibit A for examples.

(2) Most tax-exempt organizations make no profits and therefore would pay no tax on their investment income even if they were subject to income taxes. On the other hand, the excise tax option under consideration would tax a church or other tax-exempt organization but would not tax a taxable business organization with identical investment income under identical circumstances, i.e. no net profit for the year.

## Section II D. 5. a. (1)

## Income Tax on Employee Benefits

This option would limit the excludability from an employee's taxable income of the cost of employer provided health care coverages. Unless amended to incorporate a 'church plan' exemption similar to that provided for church benefit plan by ERISA, this would have a chilling effect on existing and future health care programs. For example, The Church Pension Fund, the pension fund of The Protestant Episcopal Church in the United States of America has developed a new plan to protect retired clergy and their spouses against catastrophic health care costs which are not covered by medicare or other government programs.

They have announced to the Church that the protection will be implemented on January 1, 1988. The Dioceses and the parishes will soon be preparing their 1988 budgets anticipating that the new coverages will be in place by that date. Now, if enacted, the new tax burden that option would place on the clergy will make it necessary for churches to reevaluate and possibly revise the extent of health coverage.

Respectfully submitted,

Ellen F. Cooke

Ellen F. Cooke
Treasurer

EFC:hmf

EXHIBIT A

**Examples of Taxable Organizations Not required to Pay Taxes on Net Investment Income**

- Regulated investment companies pay no income tax if they distribute all investment income to their shareholders.
- Corporations pay taxes on only 15% of investment income derived from dividends they receive from holdings of preferred stock.
- Corporations pay no income tax (hence no tax on investment income) for years in which they have no net income.
- Banks, insurance companies and other financial institutions pay no income tax on substantial amounts of investment income derived from investments in muncipal bonds.
- Depreciation, depletion, and other permissible tax accounting techniques enable businesses in many industries to eliminate or continually defer taxable income to future years, frequently offsetting investment income which otherwise would be part of the corporations' net taxable income.

**COUNCIL OF JEWELRY APPRAISER ORGANIZATIONS**
**OFFICE OF SECRETARY-TREASURER**
**P.O. BOX 6558 ANNAPOLIS, MD 21401-0558**

4 August 1987

Ms. Laura Wilcox
United States Senate
Committee on Finance
Room SD-205
Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox:

I am writing this letter on behalf of the Council of Jewelry Appraisal Organizations and the approximate twenty-five hundred persons it represents through its member organizations; the American Society of Appraisers, the Accredited Gemologist Association, the Gemological Appraisal Association, and the National Association of Jewelry Appraisers.

We are greatly concerned about the Joint Committee on Taxation and the Committee on Ways and Means option which would place a luxury excise tax on watches and jewelry items. We believe that such a tax should be rejected because:

a) An excise tax on jewelry would raise a relatively small amount of revenue. If fact, the 1987 Joint Committee Staff Report estimates that a 10 percent tax on jewelry over $100 in value would raise only $200 million in 1988. This would meet only one percent of the Ways and Means Committee's 1988 revenue target.

b) A retail tax on jewelry sales would be costly to administer, both to the IRS and the industry. The burden of collecting, recording and transmitting the tax on literally millions of transactions would fall on hundreds of thousands of retail establishments, many of which are "mom-and-pop" stories.

c) An excise tax placed only on jewelry, rather than all consumer products, would be unfair and discriminatory. A $150 watch or a $500 engagement ring cannot fairly be called a luxury item. In today's world, most people find watches and jewelry to be a necessity. Certainly, everyone purchases jewelry, not just the wealthy. Items like caviar, silk scarves, English shoes, designer dresses and the like seem to be more representative of luxury items than moderately priced jewelry.

d) Unless all consumer products are taxed equally, an excise tax on jewelry will cause consumers to switch to the purchasing of other items that are not subject to the tax. Any tax which causes a decline in the U.S. market for jewelry to the benefit of other markets will inevitably result in a further decline in employment in an industry which has lost 7,500 jobs over the past 10 years.

e) It was precisely because of the burden, inefficiency and discriminatory nature of the jewelry excise tax that Congress repealed it in 1965. Congress should not take two steps backward and reinstitute it at the expense of particular industries.

We strongly urge the Joint Committees to reject the concept of a luxury tax on watches and jewelry because of the above mentioned considerations.

Sincerely,

James V. Jolliff

James V. Jolliff
Secretary-Treasurer
Council of Jewelry Appraisal Organizations

## Summary Statement
## of
## Mikel M. Rollyson

Submitted August 14, 1987 to
the Senate Finance Committee

I am a member of the firm of Davis Polk & Wardwell and formerly held the position of Tax Legislative Counsel in the Treasury Department's office of Tax Policy. Our firm represents numerous corporate clients, and I submit this statement in the hope that it will lead to a better understanding of the significance of some of the suggestions for raising revenues from corporate taxpayers that this Committee will be considering during the budget reconciliation process.

In summary, I recommend that most of the suggested options be rejected because they would make fundamental changes in the structure of our corporate tax system. As part of the Tax Reform Act of 1986, Congress directed the Treasury to study that system and by January 1988, report to the Congress its recommendations for change (the "Subchapter C study"). Action should not be taken on major corporate tax issues without the benefit of Treasury's report.

I do recommend that the Committee instruct the Treasury to change the consolidated return regulations to resolve what has come to be known as the Woods Investment problem. The solutions to this problem proposed by the staffs, however, are overreaching. They would result in (i) overtaxing corporate taxpayers, (ii) inappropriately denying corporate taxpayers the accelerated depreciation benefits Congress has conferred, and (iii) unnecessarily altering the fundamental structure of the consolidated return regulations, again without benefit of the Treasury's Subchapter C study. I suggest that the Committee direct Treasury to adopt a more moderate approach; one that should raise significant revenues, end the Woods Investment abuses, and yet not alter the fundamental structure of the consolidated return regulations.

Finally, I will comment on several other of the staff options that merit current consideration by the Committee.

Options that Should be Rejected

The staffs of the Joint Committee on Taxation and the Committee on Ways and Means have compiled numerous suggestions for raising revenues.* This statement relates to options listed in section II.D.9. of the Staff Report. Several of these options are of such structural significance that they should be rejected summarily. While it may be appropriate to consider them as part of an overall review of Subchapter C, changes of this significance should not be made without the benefit of hearings directed specifically at these proposals. In this category are the following options:

9(a) Intercorporate dividends received deduction
9(d) Debt financing and corporate acquisitions
9(e) Stock redemptions
9(f) Tax benefit mergers

Several other of the options seem to be inappropriate for consideration at this time because they relate to issues that were supposedly resolved in the 1986 Tax Reform Act. The Committee Chairman has indicated his unwillingness to reopen the 1986 Act, and it is inappropriate to revisit these areas at this time. I place the following options in this category:

9(g) Limit sales of losses using preferred stock
9(l) Conversion of C corporation to S status

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* See Joint Committee on Taxation, Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means (JCS-17-87), June 25, 1987. (Hereinafter cited as "Staff Report").

The Woods Investment Problem

The other options merit serious consideration. Particular attention should be given to the Woods Investment problem.

Under the consolidated return regulations, a parent corporation's basis in the stock of its subsidiary is increased by the subsidiary's undistributed earnings and profits. The purposes behind the earning and profits adjustment are to measure the equity investment the parent has in its subsidiary, prevent the parent from being taxed again on the income previously taxed to the subsidiary, and prevent the parent from taking a loss on account of items that were non-deductible by the subsidiary. Earnings and profits are adjusted downward as a result of depreciation deductions, but in 1969, Congress added Section 312(k) to require the earnings and profits adjustment to be made by reference to straight line depreciation over a longer useful life even though the taxpayer used accelerated depreciation for purposes of computing taxable income.

The current consolidated return regulations reflect the rule of Section 312(k), but are flawed in that the deferred tax liability on the difference between the accelerated and straight line depreciation amounts is not reflected in the earnings and profits calculation. The result in the consolidated return context is an overstatement of basis, and, accordingly, an understatement of gain or overstatement of loss when a subsidiary is sold. The Tax Court in Woods Investment Co. v. Commissioner, 85 T.C. 274 (1985), rejected the Internal Revenue Service's attempt to alter this result without amending the consolidated return regulations.

The Staff Report contains two suggestions for dealing with the problem.* In effect, both suggestions require that the parent's basis in the stock of the subsidiary be adjusted only to the same extent as the basis of depreciable assets held by the subsidiary.

Although the consolidated return regulations should be amended to cure the Woods Investment problem, the staff proposals go too far and would result in overtaxation. They would overtax the built-in gains attributable to the use of accelerated depreciation, and thus inappropriately deny the benefits Congress has specifically legislated. In addition, adoption of the staff proposals would require Congress to change a fundamental decision made over 20 years ago when the 1966 consolidated return regulations were adopted. Finally, the staff proposals would constitute a significant step toward mandating that stock sales be taxed as if they were asset sales. Congress should not take such a drastic step without benefit of Treasury's forthcoming Subchapter C study.

I recommend that Congress direct Treasury to adopt a more moderate solution. My proposal is explained in more detail in the attached Supplemental Statement. Simply stated, it requires that the earnings and profits calculation reflect the deferred tax liability that arises when a taxpayer claims accelerated depreciation deductions. My proposal will end the abuses available under current law while allowing Congress to defer until the completion of the Subchapter C study the decision of whether to fundamentally change the structure of the consolidated return basis adjustment rules. I urge the Congress to adopt it.

Other Options the Committee Should Consider

It may also be profitable for the Committee to examine options 9(c), (h), (i), (j) and (k). These suggestions are relatively narrow in scope, and address provisions of current law that may be susceptible of abuse. Implementing changes along the lines suggested would not require that the fundamental structure of Subchapter C be reexamined. I will describe these proposals briefly.

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* The Staff Report addresses not only the Woods Investment problem, but perceived problems that might arise under Section 312(n). For ease of presentation the Section 312(n) problems are not addressed here.

Option 9(c) addresses the amount of income or loss that passes through from a subsidiary corporation to the consolidated group. Currently, the consolidated group includes 100 percent of the subsidiary's income or loss even if the parent owns less than 100 percent of the stock of the subsidiary. This system may not accurately reflect the economic gain or loss the parent has sustained as a result of its investment in its subsidiary. Option 9(h) addresses a concern arising out of the rules governing losses claimed by parent and subsidiary corporations that do not file consolidated returns. The proposal would extinguish a subsidiary's net operating losses to the extent its parent corporation has taken a worthless stock deduction for the subsidiary stock it holds. It may be appropriate to deny those losses when the parent corporation has already claimed a loss for the same economic events.

Option 9(i) would prevent a corporate shareholder from obtaining a better tax result by using the deemed dividend rules of Section 304 than it would have received had an actual dividend been paid. As there is no policy reason to allow more favorable treatment for a deemed dividend than an actual dividend, these suggestions warrant consideration. However, Section 304 is an enormously complex provision and any changes should be carefully considered.

Option 9(j) would reduce the special relief granted to Alaska Native Corporations in the Tax Reform Act of 1986.

While it is Congress's prerogative to scale back such benefits, any such change should provide transition relief for those corporations that reasonably relied on the 1986 legislation.

Finally, option 9(k) would subject personal service corporations to the highest corporate tax, and therefore deny these corporations the benefit of the graduated rate system. It may be appropriate to view the individual shareholder of a personal service corporation as the alter ego of his corporation. Because the individual obtains the benefit of the graduated individual rate system for his income from the corporation, it may not be unreasonable to deny him an additional corporate graduated rate benefit. Such a rule would necessarily require some rather arbitrary line drawing, however, since its supporting rationale is equally applicable to closely held corporations.

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# WRITTEN STATEMENT OF MR. RICHARD D. MENDELSON ON BEHALF OF THE ESOP ASSOCIATION ON REVENUE INCREASE OPTIONS

July 17, 1987

Mr. Chairman, and members of the Senate Finance Committee: my name is Richard D. Mendelson, and I testify today on behalf of the ESOP Association of America, of which I am the president. I am also President of Katz Communications in New York City.

The ESOP Association is a national, non-profit organization with over 1,000 members, of which nearly 70% represent operating corporations with Employee Stock Ownership Plans, or ESOPs. The other members are teachers, students, companies considering ESOPs, and professional men and women who are interested in employee ownership.

The ESOP Association opposes vigorously the revenue option proposal on pages 124 through 127 of the revenue options booklet, published June 25, that would eliminate all leveraged ESOP companies.

What are leveraged ESOPs?

Well, my company, Katz Communications, is a leveraged ESOP, and it is 100% employee owned.

There are approximately 1,500 leveraged ESOP companies in the United States. Many of these companies belong to the ESOP Association, and hold leadership positions in the Association. These companies, their managers and employees are in the forefront of the growing movement toward meaningful employee ownership of capital.

Allow me to list a few examples:

- ComSonics, Inc. Harrisonburg, Virginia
- Dalton Foundries, Inc., Warsaw, Indiana
- Dentsply International, York, Pennsylvania
- Kerotest Manufacturing, Pittsburg, PA
- National Refractories, Oakland, California
- The Mad Butcher, Pine Bluff, Arkansas
- The Peoria Star Journal, Peoria, Ilinois
- Weirton Steel, Weirton, West Virginia;

and I could go on.

But, Mr. Chairman, permit me to tell about the leveraged ESOP company that I know best, Katz Communications.

Katz is a 100-year old company, founded in 1887. Today Katz represents radio and TV stations in nearly every market in the U.S. by selling spot advertising time for our client stations. We are the largest representative firm in the industry. In 1986, we sold over $1 billion in radio and TV time, and had well over 1,000 employees.

We began our employee ownership program in 1972. We were the eighth ESOP company qualified under section 401 of the Internal Revenue Code. Our IRS determination letter is dated December 27, 1971, or over 2 years before Congress enacted ERISA. The employee ownership share has grown through the leveraged ESOP until Katz became 100% employee owned in 1986. Since 1978, the value of Katz stock owned by the employees has grown from $4.00 per share to $18.50 by year-end.

As a service company to the communications and advertising industries, our most important resource is our employees. We believe our ESOP gives us the edge because our energy creates our equity. As owners, the employees' capital increases as Katz succeeds. We say at Katz that when someone retires from our company, he or she does not receive a gold watch; instead they receive enough money from their ESOP account to buy the jewelry store.

Mr. Chairman, every leveraged ESOP company is unique, but there is a growing body of evidence that ESOPs in a healthy company bring about new heights of productivity. We cite and call to your attention the White House Conference on Productivity, the President's Commission on Industrial Competitiveness, a New York Stock Exchange study, a study by the Atlanta Federal Reserve Board, the report of the Presidential Task Force on Project Economic Justice, Corey Rosen's book, Employee Ownership in America - The Equity Solution, and I could go on and on. A list of such studies is attached.

Mr. Chairman, we cannot understand why any one would consider snuffing out significant employee ownership as proposed in the revenue options booklet.

First, Mr. Chairman, we notice that during the tax reform deliberations, neither Treasury I or II would have repealed leveraged ESOPs. It was never even considered.

The proposal to eliminate ESOPs as in the revenue options booklet is not only unreasonable, it would not even raise significant revenues, because bluntly, and we believe unfortunately, there are not many employee owned corporations in America.

The proposal (many people may not realize this), would repeal legal positions recognizing leveraged ESOPs. These date back to the late 1950's, when the IRS sanctioned the first leveraged ESOP, although it was not called an ESOP back then. Please keep in mind, our ESOP was deemed tax-qualified prior to ERISA. To adopt this proposal is not to "modify" ESOP rules, but to "repeal" leveraged ESOPs.

And, Mr. Chairman, it is also a myth that leveraged ESOPs are used only to ward off hostile takeovers. The truth is that recent court decisions and informal positions by the Department of Labor, may make the employees' stock the most vulnerable to a tender offer, controlled neither by management nor the employees, but by the price offered by the corporate raider. We, the ESOP Association, are working with the Senate Labor Committee, and the Senate Banking Committee, to clarify the current confused situation, and to give employees a voice in the face of a tender offer.

Mr. Chairman, it is a myth that leveraged ESOPs are used only to dump "sick" companies on innocent employees. Of the approximately 1,500 leveraged ESOPs, around 100 were so-called "distressed" buyouts, according to the National Center for Employee Ownership. These ESOPs saved over 75,000 jobs that would have been otherwise eliminated. In nearly all of these buyouts, representatives of a bargaining unit initiated the buyout, not management.

Your Joint Committee revenue estimates prove leveraged ESOPs are not being created willy-nilly, Mr. Chairman. Setting up an ESOP is complex, and those involved must do it carefully. Anytime the ESOP is not treated fairly, the Department of Labor is likely to stop the transaction dead in its tracks, or if it slips through, bring legal action against the erring fiduciaries.

In fact, we are presently working with Secretary Brock's ERISA Advisory Committee's Work Group on ESOPs to improve DOL's enforcement of ESOP laws. The work group has tentatively decided to encourage ESOPs in buyouts - just the opposite of what is now proposed to your committee. It does so because it feels the Department may have, unintentionally, stopped nearly all leveraged ESOPs in multiple investor situations.

In short, Mr. Chairman and members of the Committee, there is no evidence that leveraged ESOPs, and the significant ownership they provide, compared to stock bonus plans, or the so-called non-leveraged ESOP, are draining the U.S. Treasury, or are set up without any oversight by Federal regulators.

Finally, Mr. Chairman, we recognize that you have a difficult task - to pass a $19 billion tax bill for 1988, and $65 billion for three years. The revenue options booklet proposes to obtain less than one half of one percent of that money by eliminating leveraged ESOPs.

We of the ESOP Association have always asserted that we speak for the "skinny" cats, and not the "fat" cats.

We recommend you give strong consideration to the ESOP Association's traditional position that tax increases should be progressive and from a broad base. We believe in the income tax system, but also know broad based consumption taxes may be fair. And, as the President of a successful firm based on selling radio and TV advertising, I cannot ignore the proposal to limit the deductibility of advertising costs on page 138 of the pamphlet. We at Katz strongly oppose this proposal, and cite it as an example of a narrowly-focused tax raising idea, instead of a broad-based approach. Also, my view on the advertising proposal illustrates that leveraged ESOPs are found in all areas of the economy, representing main-stream American business endeavors. From the ESOP Association vantage point, all businesses and their employees are intertwined with our economic well-being, and no one segment of the economy deserves to be singled out for punitive taxation.

But whatever you do, please do not go after the employees and take away their ESOP incentives.

*Broadened*
*Stock*
*Ownership*

# ISSUE BRIEF

## EMPLOYEE OWNERSHIP AND CORPORATE PERFORMANCE

The studies listed below are only some of those showing that employee ownership has significant and very positive implications for corporate performance.

1. ***1986 National Center for Employee Ownership (NCEO) study*** established the first definitive causal link between employee ownership and improved corporate performance. The ESOP companies had sales growth 5.40% faster than their competitors after their plans versus 1.89% per year before. The ESOP companies had employment growth 5.05% per year faster than their competitors after establishing their ESOP, versus 1.21% before their ESOPs. Both statistics have at least a 95% confidence level (i.e., there is only a 5% probability that the difference could be due to chance). Because the study analyzed ESOP companies performance vis-a-vis their competitors for several years both before and after their ESOPs were installed, it is certain that most of the superior performance of ESOP companies is due to ESOPs, not due to the fact that better performing companies are more likely to set up ESOPs (although that seems to be true also).

The study also found that companies which combined ownership with job-level participation programs did even better than companies which simply started an ownership plan. The most participative companies improved their performance by about 8-11% on various measures of growth as compared to their pre-ESOP performance, versus about 3.5% for the least participative.

2. ***Employee Ownership in America: The Equity Solution***, results of a four-year study by the NCEO of 37 ESOP companies found that the most important factor associated with positive employee attitudes toward ownership was a large annual contribution to the ESOP plan. Other important factors included management's attitude toward employee ownership and job-level participation opportunities. This study measured employee attitudes, but did not measure corporate performance directly.

3. ***1985 ESOP Association survey*** of 239 member companies found that 16% of the companies believed ESOPs had "strongly improved" their productivity, while 56% believed that employee motivation and productivity had "somewhat improved".

4. ***1984 University of Michigan study*** of 115 employee owned companies found that these companies performed at roughly the same level as similar conventional companies during the 1976-1982 period, but were 10% more likely to stay in business.

5. ***1984 NCEO study for the New York Stock Exchange*** of thirteen companies that were 10% or more employee owned found that these firms outperformed 62-75% of their competitors, depending on the measure used (net operating margin, return to equity, sales growth and book value per share).

6. ***The 100 Best Companies to Work For***, 1984, found that sharing ownership was one of the characteristics of desirable employers, and listed eight substantially employee owned companies among the top 100.

7. ***1984 Savvy magazine survey*** of the best companies for women to work for added nine companies to their list, five of which were substantially employee owned.

8. ***1984 McKinsey and Company study***, "The Winning Performance of Mid-Sized Growth Companies" found that these successful firms tended to share ownership with employees to a greater degree than larger firms.

9. ***1984 Atlanta Federal Reserve study*** of 22 premier companies in the South—employee ownership a common thread.

10. ***1983 NCEO study*** found that employee owned companies with a majority of their stock owned by employees generated 3 times as many net new jobs per year as non-ESOP firms.

11. ***1980 study reported in the Journal of Corporation Law*** found that companies with ESOPs had twice the annual productivity growth rate of comparable conventional firms during the 1975-79 study period.

12. ***1978 University of Michigan Survey Research Center study*** found that in a sample of 30 employee ownership companies, profits were 1.5 times as high as those in comparable conventional firms.

## STATEMENT OF

## THE EDISON ELECTRIC INSTITUTE

## DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES

JULY 16, 1987

The Edison Electric Institute (EEI) is pleased to comment on the possible options to increase revenues prepared for the Committee on Ways and Means in order to meet the reconciliation instructions contained in H.Con.Res. 93, the Concurrent Resolution on the Budget for Fiscal Year 1988. EEI is the association of the investor-owned electric utilities whose members generate and distribute approximately 75% of the nation's electricity.

The electric utility industry is opposed to the following possible options to increase revenues: 1) broad-based energy taxes such as a Btu tax or ad valorem energy tax; 2) the proposed pollution excise tax on sulfur and nitrogen emissions; and 3) any substantive changes to the Tax Reform Act of 1986.

Of major concern to the investor-owned electric utility industry are the proposals in the hearing pamphlet that seek to impose broad-based energy taxes. Particularly onerous is the proposed Btu tax on domestic energy consumption and the proposed ad valorem energy tax. Electric utilities have consistently opposed broad-based energy taxes such as these because of the adverse effect on U.S. residential and industrial customers. Historically, there has been a direct correlation between electric power use and GNP. Therefore, it would be counterproductive to impose energy taxes which would increase the cost of electricity.

Broad-based energy taxes are regressive because they have a disproportionately negative impact on our low-income customers. In addition, we are concerned about the inflationary and harmful effects such taxes on energy would have on the Nation's economy. We strongly urge the Committee on Ways and Means to reject broad-based taxes on energy consumption as a means of raising revenues.

Also of concern to our industry is the proposed pollution excise tax on sulfur and nitrogen emissions put forth by Rep. Judd Gregg (R-NH). This proposal, which appears on p. 50 of the hearing pamphlet, would establish a sulfur and nitrogen emission excise tax for the purpose of encouraging nationwide emissions reductions from fossil-fueled steam boilers. The Joint Committee on Taxation estimates the revenue effect of the proposal to be $19 billion over the three-year period of 1988-1990.

While this proposal would result in sharply higher electric rates, it would not achieve the short-term goal of emissions reductions. Utilities could not possibly build and install new pollution control equipment in this time period in addition to that already planned. Long-term coal supply contracts and the "local coal" provisions of the Clean Air Act also would constrain the industry's short-term ability to switch fuel supply based on sulfur content.

Furthermore, since 1973, electric utility sulfur emissions have decreased 17% while coal use has increased 80%. This could not have occurred without an aggressive utility industry control strategy. In addition, the industry is pursuing technologies which will burn coal cleanly, achieving both sulfur and nitrogen emissions reductions. These clean coal technologies are already in the demonstration stage and will provide a more economic and efficient method of producing electricity. We urge the Committee not to consider this pollution excise tax.

The electric utility industry actively supported tax reform, despite the loss of many capital formation incentives, because of the overall favorable impact on our customers. Therefore, we believe that the Tax Reform Act of 1986 should be given a chance to work and, thus, strongly oppose any changes to the Act that would negatively affect this carefully-crafted compromise enacted less than one year ago. Many of the proposed revenue options will have negative effects on our customers by increasing the cost of electricity (corporate tax rate increases/surcharges), increasing the cost of capital (the dividends received deduction) and decreasing cash flow (broadening the alternative minimum tax).

We appreciate the opportunity to provide our comments on this important work of the Committee.

# TESTIMONY PRESENTED TO THE SENATE FINANCE COMMITTEE REGARDING EXCISE TAXES
JULY, 1987
BY FRED G. BOND, CHIEF EXECUTIVE OFFICER
FLUE-CURED TOBACCO COOPERATIVE STABILIZATION CORPORATION

I am Fred G. Bond, Chief Executive Officer of the Flue-Cured Tobacco Cooperative Stabilization Corporation in Raleigh, NC. Our association, under contract with the US Department of Agriculture, administers the price support component of the federal tobacco program for flue-cured tobacco growers in the six states of Virginia, North Carolina, South Carolina, Georgia, Florida and Alabama. Some 60,000 active farmers depend upon tobacco for their livelihood.

Through loans from the USDA's Commodity Credit Corporation, we make loans to growers for their tobacco which does not receive auction bids by commercial buyers above price support levels. As you may know, Congress has mandated that the tobacco program must operate at no net cost to the government.

Last year, Congress passed legislation which significantly altered the tobacco program and made it possible for our Cooperative to substantially reduce excess inventories. Therefore, we are very concerned about the factors which reduce demand for US grown flue-cured tobacco, one of the major ingredients in cigarettes.

We know from past experience that increases in cigarette excise taxes inevitably result in decreases in cigarette consumption. This, in turn, has a negative impact on the amount of leaf tobacco purchased at auction. Thus, growers sell less tobacco and the Cooperative receives more leaf, thus raising the amount of money we must borrow from the federal treasury and increasing the financial burden on our growers. Not only do growers receive less money, but their financial obligation for tobacco placed under loan goes up. Hence, they are required to pay more to underwrite the cost of the tobacco program from reduced incomes.

We have operated for one year under the revamped tobacco program. At this point, we feel changes that were made have been successful. For example, in 1986 our Cooperative received only 7 percent of total marketings. About 15 percent of total marketings was placed under loan the previous year. I think you will agree that to reduce by 50% the amount of tobacco going to the Cooperative is a significant improvement.

In addition, the 1986 legislation authorized the purchase of our 1976 through 1984 inventory by domestic cigarette manufacturers. On July 2, 1986, we signed contracts exceeding $1 billion with four domestic companies to purchase approximately 584 million pounds of tobacco over an eight-year period. The companies were required to purchase at least one-eighth, or 12.5 percent, of their share of the inventory each year. In only one year, however, approximately 51 percent of the inventory has either been delivered or placed upon purchase agreements.

Consequently, we are very concerned about anything that could disrupt the delicate balance of our new program and the buy-out agreement. A major rise in cigarette excise taxes could jeopardize the progress we have made to restore stability to our program and profitability to our growers.

We are especially concerned at this time. Flue-cured tobacco growers will begin selling their 1987 crop later this month. If Congress raises the cigarette excise tax now, then we foresee disruption of our markets. Taxes on tobacco products represent 40% for sales and excise taxes, excluding local taxes, or 35% for excise taxes only of total expenditures by consumers. This is already a big burden on one industry. Let me simply illustrate: one tobacco plant averages 18-22 leaves. In 1986, a grower received an average of 50-cents for one tobacco plant. The federal excise tax generated from that one tobacco plant amounted to 86.4-cents based upon the current federal tax of 16-cents per pack, plus 91.8-cents per plant for the average state tax of 17-cents per pack for a total of $1.78 per plant for state and federal excise taxes, excluding local taxes. One acre of tobacco then generates $5,184 in federal excise taxes alone or $10,680 for state and federal excise taxes, excluding local taxes, while the grower receives $3,040 for one acre of tobacco before his expenditures are deducted. The US government receives more than 3.5 times the revenue per acre of tobacco than the farmer. We feel we are taking more than our share of the tax burden.

Therefore, we are opposed to any increases in cigarette excise taxes.

**FINLEY, KUMBLE, WAGNER, HEINE,**
**UNDERBERG, MANLEY, MYERSON & CASEY**
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS
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BEVERLY HILLS, CALIFORNIA [illegible]
[illegible]

[illegible] PARK AVENUE
NEW YORK, NEW YORK [illegible]
[illegible]

[illegible] BRICKELL AVENUE
MIAMI, FLORIDA [illegible]
[illegible]

[illegible] EAST BROWARD BOULEVARD
FT. LAUDERDALE, FLORIDA [illegible]
[illegible]

[illegible] LTV CENTER
[illegible] ROSS AVENUE
DALLAS, TEXAS [illegible]
[illegible]

[illegible] WORLD TRADE CENTER
401 EAST PRATT STREET
BALTIMORE, MARYLAND [illegible]
[illegible]

LECONFIELD HOUSE
CURZON STREET, 5TH FLOOR
LONDON [illegible] U.K.
[illegible]

TWO FIRST NATIONAL PLAZA
[illegible] SOUTH CLARK STREET
CHICAGO, ILLINOIS [illegible]
[illegible]

SENATOR HOTEL BUILDING
1121 L STREET, SUITE [illegible]
SACRAMENTO, CALIFORNIA [illegible]
[illegible]

TWO UNITED PLAZA, SUITE [illegible]
[illegible] UNITED PLAZA BOULEVARD
BATON ROUGE, LOUISIANA [illegible]
[illegible]

[illegible] WILSHIRE BOULEVARD
LOS ANGELES, CALIFORNIA [illegible]
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# MEMORANDUM

TO: Committee on Finance

FROM: Jeffrey R. Gates, Of Counsel

DATE: July 21, 1987

RE: Why encourage expanded capital ownership?
Why encourage employee stock ownership plans (ESOPs)?

---

* Promotes a wider sharing in the capital ownership benefits of capitalism.

Note: According to a 1987 GAO Report, 89.9% of corporate stock (88% of bonds and 90.9% of business assets) are owned by just 10% of households. The top 1% of households own 58.4% of corporate stock. The top 0.5% own 45.6%. Figures include stock owned directly through mutual funds and exclude holdings of pension trusts (which hold 21.7% of corporate stock). (See Exhibit A.)

* Ensures that more taxpayers benefit from capital financing tax policies.

Note: From 1975-1982, corporate savings from the two primary capital financing tax benefits (i.e., depreciation and the investment tax credit) totalled $1,208,000,000,000. Given today's capital ownership pattern, roughly half of those tax benefits were utilized to finance additional income-producing assets for just 1% of U.S. households. (See Exhibit B.)

* Offers the only feasible approach to fostering widespread sharing in the ownership benefits of free enterprise (i.e., utilizing corporate earnings to finance equity acquisitions for employees).

Note: Practically all corporate funds are provided through three sources: (1) earnings and profits, (2) tax benefits and (3) debt -- none of which create any new owners. This "closed system" of finance is why the economy's capital base expands while its capital ownership base remains virtually unchanged. (See Exhibit C.)

* Provides a non-redistributive way to expand capital ownership; not taking one person's capital to give it to another but instead encouraging our economic future to be financed so that more people have an ownership stake and encouraging transfers in ownership to be financed to create a wider base of capital-owning households.

  Note: Annual capital expenditures nationwide nontotal approximately $400 billion per year -- roughly $6 trillion in new and replacement capital to be financed by the year 2000. If nothing is done, the existing "closed system" of finance will ensure that half of that $6 trillion will be owned by just 1% of households. (See Exhibit D.)

* Offers an economic policy that can be embraced by both conservatives ("every man a capitalist") and liberals ("cutting the working man in on a piece of the action").

* Provides a financing technique to broaden the ownership benefits attributable to mergers, acquisitions and leveraged buyouts.

  Note: Such transactions totalled $35 billion in 1980, skyrocketing to $175 billion in 1985 -- consuming enormous amounts of tax benefits and utilizing a significant portion of the economy's credit capacity while transferring phenomenal quantities of income-producing assets to a few managers, investment bankers and already-wealthy investors.

* Provides a forward-looking populist program - versus the "rearview mirror populism" represented, for example, by the estate tax or steeply regressive income taxes.

* Enhances motivation, dedication, quality, creativity and competitiveness.

* Improves productivity -- from both people and physical assets.

* Lowers absenteeism, turnover and grievances.

- Promotes a better understanding by all employees of company's goals and what is needed to achieve those goals.

- Improves the quality of working life (e.g., The 100 Best Companies to Work For in America found a close correlation between employee ownership and job satisfaction).

- Facilitates a new style of management (e.g., by encouraging the shift from a "control" management model toward a "commitment" model).

- More manager time can be spent planning and less implementing.

- Can save time and costs by flattening the organizational pyramid.

- Improves the workplace feedback gathered by those "managing by walking about."

- Promotes better labor/management relations.

- Enhances cooperation and teamwork.

- Provides a workplace context from which employee involvement programs are more likely to emerge (e.g., quality circles, participative management, etc.).

- Blurs lines between manager and managed and helps insure that traditional labor/management issues (working conditions, pay, benefits, etc.) are resolved within a climate in which both parties share a commitment to maintaining their employer's long-term viability.

- Promotes a sense of shared values, the most powerful factor underlying the superior performance of the most excellent firms (as documented in In Search of Excellence).

- Promotes mutual trust and better communications -- as employees begin to be treated as co-owners.

- Encourages a wider sharing of information within the company.

- Managing (and being managed) becomes more humane, more personal and more gratifying.

- Reduces workplace stress.

- Fosters a workplace context better able to access the untapped potential reservoir of human energies, resources and commitment -- the root source of quality, creativity and productivity in any enterprise.
- Helps avoid management mistakes (management is too important to be left solely to management).
- Encourages a focus on the needs of customers.
- Provides a way for employees to "harvest" the increased value created through superior performance (via equity sharing) without additional company cost.
- By providing a way to weave past and future into each day's work, promotes a long-term perspective among the workforce.
- Provides a fairer distribution of rewards.
- Offers a method of gain sharing that provides employees a real stake in their employer (versus the "industrial sharecropping" of profit-related pay advocated in Weitzman's The Share Economy).
- Builds ownership into a company's natural shareholders -- its employees, rather than into absentee investors and speculators.
- Promotes widespread economic autonomy (providing an opportuniry not just to be an economic input but also to own economic inputs).
- Updates government's role in promoting economic opportunity (not just jobs but also ownership).
- Enhances personal dignity ("working for ourselves").
- Empowers people.
- Promotes "patient" capital, allowing managers to manage for the long term -- rather than managing quarter-to-quarter in constant fear of a takeover.
- Provides a way to "anchor" domestic capital rather than have it flee overseas in search of lower labor costs.

- Provides a way to preserve a community's job-creating capital base (and its tax base) and to promote a company's loyalty to the community.
- Offers a more equitable way to respond to competitive realities (e.g., employees working for the same or less pay in exchange for capital accumulation and dividend income).
- Provides a way to avert plant closings (e.g., via ESOP-financed buyouts of viable operations).
- Recognizes that employees calculate "hurdle rates" differently than traditional absentee owners: for employees, maintaining their homes and their lifestyles, as well as their current jobs, are values that lead employee-owners to be more flexible -- both in terms of expected enterprise profitability and in terms of compensation.
- Enhances companies' flexibility and strength: the wider the choice of possible responses to a situation, the greater a company's chance of success (e.g., temporarily trading off cash compensation for capital accumulation).
- Promotes job security.
- Offers a new approach to "two tier" labor contracts (e.g., with older employees taking more cash out of the company and younger employees accumulating more equity in the company).
- Can operate as the quid pro quo that overcomes the "downward stickiness" of labor costs --- the oft-lamented reality that frustrates the academic elegance of free market theorists.
- Promotes respect for private property (80% of those in U.S. prisons are there for crimes against property).
- Fosters community cohesiveness.
- Enhances business continuity -- with companies sold to local employees rather than to absentee investors.
- Fosters widespread demand stimulation - with a capital source of income (dividends) supplementing labor income.

- Improves investment climate by creating a broader base of investors (the largest minority in this "capitalist" economy is comprised of those who own no significant amount of capital).

- Provides a process that enables people to gain an opportunity to participate - to give of themselves - and to feel that they are a part of something larger than themselves.

- Promotes economic and social justice.

- Increases social harmony -- by consciously creating more haves and fewer have-nots.

- Offers a new economic model for the U.S. to advocate in its foreign relations (concentrated ownership continues to be capitalism's geopolitical Achilles heel).

- Provides an exportable model of capitalism (something this nation has yet to offer) -- demonstrating how capitalism can be structured to build capital for working people.

- Demonstrates how governments can implement free enterprise principles abroad.

- Attacks the cause of poverty and dependence (i.e., a lack of "economic connectedness") rather than addressing only the effects (i.e., a lack of adequate income); a primary cause of poverty is the lack of ownership of a viable holding of productive capital in a world where the vast bulk of goods and services are produced by capital rather than by labor and where technological change relentlessly sharpens that disparity.

- Helps relieve the fiscal strain of transfer payments, tax incentives for retirement benefits and Social Security -- by promoting widespread economic self sufficiency via capital accumulation.

- Addresses the relevant economic needs of the dominant age group.

  Note: In 1988, 61.5% of the voting-age population will be under 45 years of age. Are they more interested in retirement security (e.g., pension annuities and Social Security) or economic opportunity (i.e., capital accumulation)?

- Educates people about the advantages of a free enterprise private property system by the most effective means possible -- insuring that they have a stake in it.

- Recognizes that, in a market economy, outtake (i.e., income) is based on input and that, as technology moves through time, households need to be connected to their economy's increasingly dominant inputs (i.e., productive capital and the labor-saving, job-eliminating, income-producing technology embodied therein.)

  Note: The symptoms indicating the need for a more complete method of "economic connectedness" are rapidly becoming more obvious. For example, from 1979 to 1984, white adult males experienced a 53% loss in jobs paying twice the median income while experiencing a 97% increase in jobs paying one-half the median income. The middle class is rapidly shrinking and, for the first time in history, the U.S. has a rising generation assured of having a lower standard of living than that their parents.

- Embodies an economic policy that reflects the technological reality of economic participation in a post-industrial economy.

- Promotes market-based, self-sustaining economic flows; production and consumption are two sides of the same coin -- producers need consumers with purchasing power adequate to buy their goods and services -- ESOP financing links income-needy households to consumer-needy markets.

- By humanely financing the future, ensures that this nation's technology is designed to support a broad base of those whose culture gave rise to that technology.

- By enhancing economic security, makes it possible for more people to participate in cultural activities (leisure, music, religion, politics, education, child-rearing, etc.)

- Promotes environmental responsibility without increased government regulation by encouraging local versus absentee ownership or, as economists phrase it, "localizing control over the externalities".

- Recognizes (as a Federal system should) that the States (19 to date) are actively promoting employee ownership but there is a limit to their capacity to effectively advance an idea so dependent on the national agenda.

- Recognizes that finance is itself a type of techonology -- e.g., its practitioners use technological terms to describe its workings, such as "leverage" (from the technology of mechanics) and cash "flow" (from hydraulic technology); thus, that financial technology can be adapted so that it operates to economically empower many households rather than just a few.

- Recognizes that social institutions (including the institutions and conventions of finance) are a bit like evolution -- they change in bursts, experiencing long periods with very little change interspersed with periods of rapid, often intense change: our institutions badly need an evolutionary change - a change totally dependent on political will.

- Establishes not a firm destination but a better defined and a more hopeful sense of economic direction.

- Provides a vision that serves as a challenge.

- Provides a national strategy that focuses less on the symbols of national unity and more on a strategy that can foster a true national unity - a unity that can command respect, nationally and internationally, over a long period of time.

0101r

EXHIBIT A

**Table 4.1: Assets of All Households and of the Wealthiest Households, 1983**

| Type of asset | All households amount[a] | Percent of total for Wealthiest households: Top 0.5% | Top 1% | Top 10% |
|---|---|---|---|---|
| Trusts | $495.7 | 77.0% | 81.6% | 95.1% |
| Corporate stock[b] | 1,005.0 | 45.6 | 58.4 | 89.8 |
| Bonds | 328.1 | 41.3 | 49.6 | 88.0 |
| Business assets | 2,274.6 | 39.0 | 51.6 | 90.9 |
| Money market accounts | 265.0 | 15.9 | 22.5 | 58.6 |
| Real estate | 5,365.0 | 14.9 | 19.3 | 49.2 |
| Land contracts | 111.0 | 13.9 | 15.2 | 50.4 |
| IRAs and Keoghs | 142.2 | 13.0 | 21.1 | 67.3 |
| Checking accounts | 115.9 | 9.7 | 17.2 | 46.3 |
| Insurance cash surrender value | 259.8 | 6.7 | 10.5 | 34.9 |
| Certificates of deposit | 363.1 | 4.8 | 10.7 | 49.9 |
| Savings accounts | 186.5 | 2.1 | 5.2 | 31.1 |
| Automobiles | 359.5 | 1.6 | 3.0 | 20.1 |
| Miscellaneous | 201.1 | 15.2 | 22.1 | 70.2 |
| **Gross assets** | **11,486.4** | **24.6** | **31.6** | **63.5** |
| **Net worth** | **10,038.9** | **26.7** | **34.3** | **67.92** |

[a] In billions of dollars.

[b] Including stock owned directly or through mutual funds, but excluding holdings of pension plan trusts.

Source: U.S. Congress, Joint Economic Committee, The Concentration of Wealth in the United States: Trends in the Distribution of Wealth among American Families (Washington: Joint Economic Committee, 1986), p. 24. The figures in the table are based on revised estimates provided to us by the Federal Reserve Board following publication of the Joint Economic Committee report.

ESOPs appear to provide a broader distribution of stock ownership than generally prevails (not accounting for pension funds or insurance company holdings). ESOPs are subject to the Internal Revenue Code coverage and nondiscrimination rules applicable to all qualified employee plans. Thus, broad participation in ownership of the sponsoring corporation's stock is a condition for corporate use of tax advantages related to ESOPs. Based on data from the IRS, the median rate of employee participation for all ESOPs is nearly 71 percent. This proportion does not vary much among the types of ESOPs, although the median for tax credit ESOPs, less than 63 percent, is somewhat lower than for other types. Assuming that the employees of firms with ESOPs include workers who differ widely in levels of wealth and income, then the high proportion of these workers participating in stock ownership through ESOPs suggests that these plans do broaden stock ownership within sponsoring firms.

## EXHIBIT B

### Table 15

### Major Corporate Savings from Investment Tax Credits and Depreciation Deductions in 1975–82[a]

| | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | Total |
|---|---|---|---|---|---|---|---|---|---|
| Investment credit | | | | | | | | | |
| Total allowed | $6,480 | $9,153 | $11,038 | $12,097 | $14,635 | $15,103 | $18,887 | $17,313 | $105,486 |
| Tentative | 8,586 | 11,266 | 14,034 | 15,819 | 19,041 | 20,853 | 26,002[b] | 24,659[b] | 142,259 |
| 7% | 1,170 | 210 | 98 | 53 | 8 | c | c | c | 1,539 |
| 10% | 7,112 | 10,609 | 13,286 | 15,018 | 18,028 | 19,765 | 24,619[d] | 23,166[d] | 133,788 |
| 1% ESOP | 194 | 447 | 571 | 648 | 806 | 859 | 1,091 | 1,173 | 5,698 |
| 0.5% ESOP | c | c | 79 | 118 | 180 | 196 | 258 | 298 | 1,122 |
| Patrons' regular | c | c | c | c | 20 | 32 | 38 | 22 | 113 |
| Depreciation deduction | $86,296 | $93,762 | $106,971 | $121,300 | $138,062 | $157,346 | $186,195 | $213,179 | $1,103,112 |
| Maximum tax rate | 48% | 48% | 48% | 48% | 46% | 46% | 46% | 46% | |
| Estimated tax savings | $41,422 | $45,006 | $51,347 | $58,224 | $63,508 | $72,379 | $85,650 | $98,062 | $515,598 |

[a] Current dollars in millions. The difference between our estimate of the cost of ESOPs tax credits, $8.9 billion, in table 14 and the IRS estimate, $6.8 billion, is explained by three factors: (1) our data cover 1977–83 and the IRS data cover 1975–82 (for 1977–82, years covered in both tables, our estimate of tax credit cost is $7.7 billion and the IRS estimate is $6.3 billion); (2) we assume that all contributions were claimed in the year of contribution, whereas IRS includes only the amounts actually claimed in each year (there are carryover provisions for the credits); and (3) different sampling frames were used in drawing the two samples, which may therefore represent somewhat different populations.

[b] Because of a change in the statistics-of-income reporting procedures, these numbers are not perfectly comparable to the numbers in the tentative investment credit category for previous years, and they come from a slightly different category, but they closely approximate the actual figures.

[c] Not applicable.

[d] This category was not reported in statistics of income for 1981 or 1982. The numbers reported here represent the difference between the tentative investment credit and the total of the ESOPs credits plus the patrons' regular investment credit for each year.

Source: Internal Revenue Service, Statistics of Income: Corporation Income Tax Returns Washington, D.C.: U.S. Government Printing Office, 1975–82.

## EXHIBIT C

### Table 16

### The Sources of Funds for Nonfarm, Nonfinancial Corporations in Selected Years 1955–85[a]

| | 1955 | 1960 | 1965 | 1970 | 1975 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Total | $52,660 | $48,622 | $91,840 | $102,344 | $156,953 | $335,231 | $364,155 | $309,360 | $436,349 | $482,597 | $449,520 |
| Internal | 55.9% | 72.8% | 63.7% | 60.4% | 76.2% | 56.5% | 63.3% | 75.7% | 64.3% | 69.4% | 79.0% |
| Retained earnings | 22.4 | 16.5 | 20.8 | 7.4 | 21.7 | 14.6 | 12.6 | 3.3 | 4.3 | 7.1 | 5.5 |
| Capital consumption allowance | 36.1 | 54.8 | 35.4 | 50.6 | 59.8 | 50.1 | 52.0 | 66.9 | 49.3 | 47.3 | 53.1 |
| Iva and cca[b] | -7.1 | -4.7 | 2.7 | -4.0 | -13.5 | -17.1 | -8.1 | -1.8 | 5.0 | 10.2 | 15.2 |
| Foreign earnings | 4.5 | 6.2 | 4.8 | 6.4 | 8.3 | 8.9 | 6.7 | 7.2 | 5.7 | 4.8 | 5.2 |
| External | 44.1% | 27.2% | 36.3% | 39.6% | 23.8% | 43.5% | 36.7% | 24.3% | 35.7% | 30.6% | 21.0% |
| New equity issues | 3.3 | 2.8 | c | 5.6 | 6.3 | 3.8 | -3.1[d] | 3.7 | 6.5 | -16.0[d] | -18.9[d] |
| Debt | 16.0 | 22.0 | 20.0 | 28.9 | 13.3 | 23.3 | 28.3 | 22.6 | 13.6 | 36.4 | 31.8 |
| Other | 24.8 | 2.4 | 16.1 | 5.2 | 4.2 | 16.3 | 11.6 | -2.1 | 15.6 | 10.2 | 8.2 |

[a] Dollars current in millions, adjusted seasonally but not annually for inflation. All figures based on quarterly estimates, except 1985 based on first-quarter estimates only.

[b] iva = inventory valuation adjustment; cca = capital consumption adjustment.

[c] Less than 0.05 percent.

[d] Indicates firms bought more stock than they issued.

Source: Flow of Funds Section, Federal Reserve Board, Washington, D.C.

EXHIBIT D

### Table B-51.—*Business expenditures for new plant and equipment, 1947–87*

[Billions of dollars; quarterly data at seasonally adjusted annual rates]

| Year or quarter | Industries surveyed quarterly | | | | | | | | | Addenda | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | All industries | Manufacturing | | | Nonmanufacturing | | | | | Total nonfarm business[2] | Manufacturing | Nonmanufacturing | | |
| | | Total | Durable goods | Nondurable goods | Total[1] | Mining | Transportation | Public utilities | Commercial and other | | | Total | Surveyed quarterly | Surveyed annually[3] |
| 1947 | 20.11 | 8.73 | 3.39 | 5.34 | 11.38 | 0.69 | 2.69 | 1.64 | 6.38 | 22.27 | 8.73 | 13.54 | 11.38 | 2.16 |
| 1948 | 22.78 | 9.25 | 3.54 | 5.71 | 13.53 | .92 | 3.17 | 2.67 | 6.77 | 25.97 | 9.25 | 16.73 | 13.53 | 3.19 |
| 1949 | 20.28 | 7.32 | 2.68 | 4.64 | 12.96 | .80 | 2.88 | 3.25 | 6.04 | 24.03 | 7.32 | 16.72 | 12.96 | 3.76 |
| 1950 | 21.56 | 7.73 | 3.22 | 4.51 | 13.83 | .84 | 2.87 | 3.42 | 6.70 | 25.81 | 7.73 | 18.08 | 13.83 | 4.25 |
| 1951 | 26.81 | 11.07 | 5.12 | 5.95 | 15.74 | 1.11 | 3.59 | 3.75 | 7.29 | 31.38 | 11.07 | 20.31 | 15.74 | 4.57 |
| 1952 | 28.16 | 12.12 | 5.75 | 6.37 | 16.04 | 1.21 | 3.56 | 3.96 | 7.31 | 32.16 | 12.12 | 20.04 | 16.04 | 4.00 |
| 1953 | 29.96 | 12.43 | 5.71 | 6.72 | 17.53 | 1.25 | 3.56 | 4.61 | 8.09 | 34.20 | 12.43 | 21.77 | 17.53 | 4.23 |
| 1954 | 28.85 | 12.00 | 5.49 | 6.51 | 16.85 | 1.29 | 2.91 | 4.23 | 8.42 | 33.62 | 12.00 | 21.62 | 16.85 | 4.76 |
| 1955 | 30.94 | 12.50 | 5.87 | 6.62 | 18.44 | 1.31 | 3.10 | 4.26 | 9.77 | 37.08 | 12.50 | 24.58 | 18.44 | 6.14 |
| 1956 | 37.90 | 16.33 | 8.18 | 8.15 | 21.57 | 1.64 | 3.56 | 4.78 | 11.59 | 45.25 | 16.33 | 28.91 | 21.57 | 7.34 |
| 1957 | 40.54 | 17.50 | 8.59 | 8.91 | 23.04 | 1.69 | 3.84 | 5.95 | 11.58 | 48.62 | 17.50 | 31.11 | 23.04 | 8.07 |
| 1958 | 33.84 | 12.98 | 6.21 | 6.77 | 20.86 | 1.43 | 2.73 | 5.74 | 10.97 | 42.55 | 12.98 | 29.57 | 20.86 | 8.71 |
| 1959 | 35.88 | 13.76 | 6.72 | 7.04 | 22.12 | 1.35 | 3.47 | 5.46 | 11.84 | 45.17 | 13.76 | 31.41 | 22.12 | 9.29 |
| 1960 | 39.44 | 16.36 | 8.30 | 8.06 | 23.08 | 1.29 | 3.54 | 5.40 | 12.86 | 48.99 | 16.36 | 32.63 | 23.08 | 9.55 |
| 1961 | 38.34 | 15.53 | 7.40 | 8.13 | 22.80 | 1.26 | 3.14 | 5.20 | 13.21 | 48.14 | 15.53 | 32.61 | 22.80 | 9.81 |
| 1962 | 40.86 | 16.03 | 7.81 | 8.22 | 24.83 | 1.41 | 3.59 | 5.12 | 14.71 | 51.61 | 16.03 | 35.58 | 24.83 | 10.75 |
| 1963 | 43.67 | 17.27 | 8.64 | 8.63 | 26.40 | 1.26 | 3.64 | 5.33 | 16.17 | 53.59 | 17.27 | 36.33 | 26.40 | 9.93 |
| 1964 | 51.26 | 21.23 | 10.98 | 10.25 | 30.04 | 1.33 | 4.71 | 5.90 | 18.10 | 62.02 | 21.23 | 40.80 | 30.04 | 10.76 |
| 1965 | 59.52 | 25.41 | 13.49 | 11.92 | 34.12 | 1.36 | 5.66 | 6.43 | 20.68 | 70.79 | 25.41 | 45.39 | 34.12 | 11.27 |
| 1966 | 70.40 | 31.37 | 17.23 | 14.15 | 39.03 | 1.42 | 6.60 | 7.92 | 23.11 | 82.62 | 31.37 | 51.25 | 39.03 | 12.22 |
| 1967 | 72.75 | 32.25 | 17.83 | 14.42 | 40.50 | 1.38 | 6.57 | 9.33 | 23.22 | 83.82 | 32.25 | 51.57 | 40.50 | 11.07 |
| 1968 | 76.42 | 32.34 | 17.90 | 14.44 | 44.08 | 1.44 | 6.91 | 10.52 | 25.22 | 88.92 | 32.34 | 56.58 | 44.08 | 12.50 |
| 1969 | 85.74 | 36.27 | 19.97 | 16.31 | 49.47 | 1.77 | 7.23 | 11.70 | 28.77 | 100.02 | 36.27 | 63.74 | 49.47 | 14.27 |
| 1970 | 91.91 | 36.99 | 19.80 | 17.19 | 54.92 | 2.00 | 7.17 | 13.03 | 32.71 | 106.15 | 36.99 | 69.16 | 54.92 | 14.24 |
| 1971 | 92.91 | 33.60 | 16.78 | 16.82 | 59.31 | 2.67 | 6.42 | 14.70 | 35.52 | 109.18 | 33.60 | 75.58 | 59.31 | 16.27 |
| 1972 | 103.40 | 35.42 | 18.22 | 17.20 | 67.98 | 2.45 | 7.14 | 16.26 | 41.89 | 120.91 | 35.42 | 85.49 | 67.98 | 17.51 |
| 1973 | 120.03 | 42.35 | 22.63 | 19.72 | 77.67 | 3.30 | 8.66 | 17.99 | 48.30 | 139.25 | 42.35 | 96.91 | 77.67 | 19.24 |
| 1974 | 139.67 | 52.48 | 26.77 | 25.71 | 87.19 | 4.58 | 9.16 | 19.96 | 53.49 | 159.83 | 52.48 | 107.35 | 87.19 | 20.16 |
| 1975 | 142.42 | 53.66 | 25.37 | 28.29 | 88.76 | 6.12 | 9.95 | 20.23 | 52.47 | 162.61 | 53.66 | 108.95 | 88.76 | 20.19 |
| 1976 | 158.44 | 58.53 | 27.50 | 31.03 | 99.91 | 7.63 | 11.19 | 22.90 | 58.20 | 179.91 | 58.53 | 121.38 | 99.91 | 21.47 |
| 1977 | 184.82 | 67.48 | 32.77 | 34.71 | 117.34 | 9.81 | 12.20 | 27.83 | 67.51 | 208.15 | 67.48 | 140.67 | 117.34 | 23.33 |
| 1978 | 217.76 | 78.58 | 39.46 | 39.13 | 139.18 | 11.22 | 13.38 | 31.50 | 83.08 | 245.34 | 78.58 | 166.76 | 139.18 | 27.58 |
| 1979 | 254.96 | 95.92 | 48.50 | 47.42 | 159.04 | 12.51 | 16.05 | 35.63 | 94.85 | 284.94 | 95.92 | 189.02 | 159.04 | 29.98 |
| 1980 | 282.80 | 112.33 | 55.35 | 56.98 | 170.47 | 15.99 | 16.60 | 37.74 | 100.14 | 314.47 | 112.33 | 202.15 | 170.47 | 31.68 |
| 1981 | 315.22 | 126.54 | 59.81 | 66.73 | 188.68 | 21.38 | 15.84 | 41.21 | 110.24 | 349.26 | 126.54 | 222.72 | 188.68 | 34.04 |
| 1982 | 310.98 | 120.68 | 55.35 | 65.33 | 190.30 | 20.05 | 14.79 | 45.43 | 110.03 | 347.47 | 120.68 | 226.79 | 190.30 | 36.49 |
| 1983 | 304.78 | 116.20 | 53.08 | 63.12 | 188.58 | 15.19 | 13.97 | 44.96 | 114.46 | 343.35 | 116.20 | 227.15 | 188.58 | 38.57 |
| 1984 | 354.44 | 138.82 | 66.24 | 72.58 | 215.61 | 16.86 | 16.52 | 47.48 | 134.75 | 398.98 | 138.82 | 260.16 | 215.61 | 44.55 |
| 1985 | 387.13 | 153.48 | 73.27 | 80.21 | 233.65 | 15.88 | 18.02 | 48.81 | 150.94 | 431.94 | 153.48 | 278.46 | 233.65 | 44.81 |
| 1986[4] | 380.68 | 144.77 | 69.96 | 74.81 | 235.91 | 11.24 | 18.64 | 46.93 | 159.10 | | 144.77 | | 235.91 | |
| 1987[4] | 384.24 | 141.95 | 69.51 | 72.44 | 242.30 | 10.11 | 18.86 | 44.42 | 168.91 | | 141.95 | | 242.30 | |
| 1985: I | 373.56 | 146.94 | 70.29 | 76.64 | 226.62 | 15.81 | 16.70 | 48.44 | 145.68 | | 146.94 | | 226.62 | |
| II | 387.86 | 154.25 | 74.34 | 79.91 | 233.61 | 16.56 | 17.46 | 48.61 | 150.98 | | 154.25 | | 233.61 | |
| III | 389.23 | 154.47 | 72.99 | 81.48 | 234.76 | 15.88 | 18.61 | 48.64 | 151.62 | | 154.47 | | 234.76 | |
| IV | 397.86 | 158.26 | 75.47 | 82.79 | 239.61 | 15.25 | 19.15 | 48.79 | 156.42 | | 158.26 | | 239.61 | |
| 1986: I | 377.94 | 144.03 | 68.61 | 75.42 | 233.90 | 12.98 | 18.22 | 47.03 | 155.67 | | 144.03 | | 233.90 | |
| II | 375.92 | 141.68 | 68.33 | 73.35 | 234.24 | 11.23 | 18.28 | 46.55 | 158.18 | | 141.68 | | 234.24 | |
| III | 374.55 | 139.21 | 69.31 | 69.90 | 235.34 | 10.15 | 19.03 | 45.90 | 160.25 | | 139.21 | | 235.34 | |
| IV[4] | 394.34 | 154.17 | 74.17 | 80.00 | 240.17 | 10.82 | 19.82 | 46.63 | 162.91 | | 154.17 | | 240.17 | |
| 1987: I[4] | 386.82 | 141.22 | 67.86 | 73.36 | 245.60 | 10.36 | 19.85 | 46.32 | 169.08 | | 141.22 | | 245.60 | |
| II[4] | 393.39 | 145.23 | 72.37 | 72.86 | 248.16 | 10.50 | 18.46 | 46.98 | 172.22 | | 145.23 | | 248.16 | |

[1] Excludes forestry, fisheries, and agricultural services; medical services; professional services; social services and membership organizations; and real estate, which, effective with the April–May 1984 survey, are no longer surveyed quarterly. See last column ("nonmanufacturing surveyed annually") for data for these industries.

[2] "All industries" plus the part of nonmanufacturing that is surveyed annually.

[3] Consists of forestry, fisheries, and agricultural services; medical services; professional services; social services and membership organizations; and real estate.

[4] Planned capital expenditures as reported by business in late October and November 1986, corrected for biases.

Source: Department of Commerce, Bureau of Economic Analysis.

Statement of
Edward W. Stimpson
President
General Aviation Manufacturers Association

The General Aviation Manufacturers Association (GAMA) represents companies that collectively account for 95 percent of our nation's general aviation manufacturing activity. We represent builders of airframes, engines, avionics and other component parts of aircraft. We welcome the opportunity to comment on specific revenue options contained in the Joint Tax Committee's (JCT) staff pamphlet published on June 25, 1987.

The JCT proposes the possible reimposition of excise taxes on articles previously taxed. In addition, the JCT suggests a 10 percent luxury tax on a number of new articles, including boats and yachts, china and crystal, and others -- such as business airplanes.

Business airplanes are not a luxury item. They contribute to a company's business objectives just like new plants, machine tools and other capital equipment. They provide essential transportation support, usually with meaningful economies of time, money and responsiveness. They must not be compared with yachts and other glamorous, widely-perceived luxury items. In fact, the Tax Code provides for the collection of personal income taxes for any personal use of business airplanes. Indeed they are strictly business assets, not luxury items.

Following airline deregulation in 1978, airports serviced by commercial airlines have been reduced significantly. The hub and spoke system has further changed patterns of airline travel.

During the same period, we have seen considerable dispersal of operating locations throughout America. These factors, along with delays inherent in airline travel, have increased the relative demand for business aircraft, and frankly, have managed to sustain our industry.

Business aircraft are operated by both large and small businesses. Many individually-owned companies in addition to larger corporations utilize business aircraft. I am enclosing two publications which portray typical operations of business airplanes.

The price of new aircraft has been a major factor in depressed industry sales. Factors such as product liability costs have drastically increased the price of aircraft, particularly the smaller piston plane. The JCT proposal would further increase costs for the consumer.

The JCT estimates the revenue effects to be $200-300 million in each of the next three years. That assumes sales of $2-3 billion per year. U.S. manufacturers' sales in 1986 totaled $1.2 billion on 1,495 units. Unit sales in 1987 should approximate 1,000 units. Foreign sales in the U.S. are typically less than domestic sales. Add the proposed 10 percent luxury tax and there would be some additional reduction in sales which would further reduce the level and accuracy of revenue estimates.

Notwithstanding the revenue levels anticipated, what are the estimated costs of collection and enforcement? How many more jobs would these taxes wrest from an industry struggling to stay alive? And how could the Congress justify the imposition of a luxury tax on something so necessary as business transportation? These are questions that inevitably lead to a rejection of the general aviation luxury tax proposal. It simply is not justified.

For the last several years, business aviation has been overwhelmed with proposed tax changes. While some of these have been modified, others have been enacted and are having a negative impact on aircraft sales. Among these are:

- Repeal of the Investment Tax Credit.
- Changes in the Investment Tax Credit while it was still applicable (ie. percent of business use to qualify for ITC.)
- Change in depreciation schedules.
- Fringe Benefit and Empty Seat Rules.
- Increases in fuel taxes.
- Previous proposals for luxury taxes.

Actions by the Congress should be taken to stabilize and assist industry, not penalize them as this luxury tax would. Industry unemployment is currently down nearly 70 percent from 1981 levels. Imposition of this tax would make the situation even worse.

Statement of

Lester P. Lamm

President

## Highway Users Federation

Mr. Chairman and members of the Committee on Finance, I am Lester Lamm, President of the Highway Users Federation. The Federation is a national coalition of businesses, industries, and associations, working cooperatively to make America's highway transportation system safer and more efficient. Our membership, composed of more than 400 companies and industry associations, 62 affiliated state and local highway user conferences, and more than 2,000 individual business men and women, represent the chief users of highways and the main providers of highway transportation products and services.

We welcome this opportunity to present our views on revenue options for inclusion in the July 15-17, 1987 hearing record of the Committee on Finance.

The Federation has reviewed the Joint Committee Print which describes possible options to increase revenues, with particular attention to motor fuel excise taxes.

There are a number of compelling reasons why a motor fuel tax for deficit reduction is a bad idea:

- Gasoline is already heavily taxed: based on national averages, total taxes on a 98.7 cent gallon of gasoline range from 27 cents to 37 cents.
- There are geographic inequities: rural and small town Americans drive about 40 percent more miles daily than urban dwellers, and hence must shoulder nearly half again more of the deficit reduction burden if gasoline taxes are hiked for this purpose.
- Automobile use is not a luxury: nearly 70 percent of all trips are either work-related or are for family business.

- The poor are hardest hit by such a tax: low income families would be required to pay more than three times as much for deficit reduction relative to their income as their more affluent neighbors.
- Highways pay their way: highway transportation has not contributed to the national deficit, and the Federal Highway Trust Fund is required by Congress to always have enough funds to cover expenditures.
- The tax could preempt the states' highway revenue resource: states traditionally have looked to motor fuel taxes to fund essential highway programs. A Federal motor fuel tax hike for deficit reduction would substantially deter states from raising their fuel taxes, notwithstanding identified highway needs.

Motor fuel is already one of the most heavily taxed essential commodities in the United States: the 9 cent Federal motor fuel excise tax, state and local excise taxes averaging 14.1 cents per gallon (in some states they are as high as 20 cents per gallon), and state severance taxes that range from a nickel to 15 cents a gallon (See Exhibit I). Indirect taxes on the production of gasoline are also passed along to the consumer.

By any standard, gasoline pays its share. Moreover, should gasoline prices drop, the taxes become a larger and larger part of consumer cost. And unlike other taxes which are hidden, or only cause anguish when annual payment is due, motor fuel taxpayers are reminded every time they go to the pump. At this time of year, family vacations are high on the agendas of millions of Americans, and auto travel represents the largest percentage of all travel in the U.S. The constant reminder to motorists that a substantial part of their fuel tax is going for deficit reduction instead of fixing up the roads they are using and are willing to pay for, may indeed be a good political reason to reject the proposed tax hike.

The amounts of money involved are not trivial. According to the National Association of State Budget Officers, increasing motor fuel taxes by 12 cents for non-transportation spending would create a $3.4 billion shortfall in the Highway Trust Fund over the next five years -- the life of the current law. Diminished fuel consumption would cause an additional $4 billion to be irrevocably lost to state treasuries over the same period.

The recently released 1987 STATUS OF THE NATION'S HIGHWAYS: CONDITIONS AND PERFORMANCE, submitted to Congress by the U.S. Department of Transportation pursuant to Section 307 of Title 23, United States Code, highlights some problems of very serious concern to highway users:

- "..future travel demand is anticipated to increase an average of 2.85 percent annually through the year 2000, reaching 2.7 trillion miles by the turn of the century;"
- "..congestion has worsened since 1983, with the percent of peak hour travel on urban interstates under congested conditions increasing from 54 percent to almost 61 percent;"
- "..bridge conditions generally deteriorated over the two-year period 1984-1986, when the proportion of Interstate bridges classified as being deficient rose from 10.6 percent in 1982 to 13.1 percent in 1984, and 14.3 percent in 1986."

The true irony of the current Federal tax hike proposals is that none of the revenues would build or fix a single highway or bridge, or ease congestion on vital urban arteries, at a time when needs are rapidly outpacing available funds, and when other Congressional budget constraints are already cutting back on revenues which should be made available to the states from the Highway Trust Fund.

We support repealing the six cents gasohol exemption from the Federal motor fuel excise tax. The current subsidy had some justification when it was assisting a fledgling alcohol industry get under way. That rationale no longer holds. The Department of Agriculture estimates, based on the 1986 production cost of corn-based ethanol at $1.60 per gallon, that increasing the annual fuel ethanol production from the current 600 plus million gallons to two billion gallons -- with present tax exemptions -- would cost Federal and state governments more than $6.1 billion by 1995, and eliminating the exemption would save more than $6.5 billion by 1995.

Finally, the Highway Users Federation strongly supports measures which would curb evasion of lawfully imposed motor fuel taxes. According to the Federal Highway Administration, and estimated $1 billion may not now be collected for deposit in the Highway Trust Fund at today's excise tax level, and of course higher rates would provide added incentive to evade. In the final analysis, highway users are the ultimate victims when motor fuel taxes, intended to improve the nation's highway transportation facilities, are evaded.

We are at the threshhold of the post-Interstate era, but there is no national highway policy beyond Fiscal Year 1991 when current authorizations expire. It will be up to the Congress to craft a national highway program that will effectively serve America's needs into the 21st century. It is then that the question of increased motor fuel taxes, specifically to pay for road needs, should be debated, not now, and not for general revenue enhancement purposes.

The proposed hike of the Federal motor fuel tax for deficit reduction purposes sets a dangerous precedent which could adversely affect the future Federal-state highway partnership. The present strength and solidarity of that partnership has already been severely tested during the many months of delayed reauthorizations, delayed Interstate Cost Estimate approvals, and cut backs in funding levels preceding enactment of the 1987 Surface Transportation and Uniform Relocation Assistance Act.

We believe these are compelling reasons why a motor fuel tax hike for deficit reduction is a bad idea, and we would urge the Committee on Finance to dismiss it once and for all.

Thank you.

Statement of Lester P. Lamm, Highway Users Federation **EXHIBIT I**

# STATE MOTOR FUEL TAX RATES

(cents per gallon)

| STATE | GASOLINE | DIESEL | GASOHOL | ADDED TAX (1) | LOCAL OPTION |
|---|---|---|---|---|---|
| ALABAMA | 13 | 14 | 9 | | L |
| ALASKA | 8 | 8 | 0 | | |
| ARIZONA | 16 | 16 | 16 | | |
| ARKANSAS | 13.5 | 12.5 | 13.5 | | |
| CALIFORNIA | 9 | 9 | 9 | 6 | L |
| COLORADO | 18 | 20.5 | 18 | | |
| CONNECTICUT | 18 | 18 | 17 | 2 | |
| DELAWARE | 13 | 13 | 13 | | |
| D.C. | 15.5 | 15.5 | 15.5 | | |
| *FLORIDA | 9.7 | 14.7 | 5.7 | | L |
| GEORGIA | 7.5 | 7.5 | 7.5 | 3 | |
| HAWAII | 11 | 11 | 11 | 4 | L |
| IDAHO | 14.5 | 14.5 | 10.5 | | |
| ILLINOIS | 13 | 15.5 | 13 | 6 | L |
| INDIANA | 14 | 15 | 14 | 5 | |
| IOWA | 16 | 18.5 | 15 | | |
| *KANSAS | 11 | 13 | 11 | | |
| *KENTUCKY | 15 | 12 | 15 | | |
| LOUISIANA | 16 | 16 | 16 | 1 | |
| MAINE | 14 | 14 | 11 | | |
| MARYLAND | 18.5 | 18.5 | 18.5 | | |
| *MASSACHUSETTS | 11 | 11 | 11 | | |
| *MICHIGAN | 15 | 15 | 15 | 4 | |
| MINNESOTA | 17 | 17 | 15 | | |
| MISSISSIPPI | 15 | 16 | 15 | | L |
| MISSOURI | 11 | 11 | 11 | | |
| MONTANA | 20 | 20 | 20 | | |
| *NEBRASKA | 17.8 | 17.6 | 14.6 | | |
| NEVADA | 16 | 17 | 16 | | L |
| NEW HAMPSHIRE | 14 | 14 | 14 | | |
| NEW JERSEY | 8 | 11 | 0 | | |
| NEW MEXICO | 14 | 16 | 6 | | L |
| NEW YORK | 8 | 10 | 8 | 6.75 | L |
| *NORTH CAROLINA | 15.75 | 15.75 | 15.75 | | |
| NORTH DAKOTA | 17 | 17 | 13 | | |
| *OHIO | 14.7 | 14.7 | 14.7 | | |
| OKLAHOMA | 16 | 13 | 16 | | |
| OREGON | 12 | 12 | 12 | | L |
| PENNSYLVANIA | 12 | 12 | 12 | 6 | |
| *RHODE ISLAND | 15 | 15 | 15 | | |
| SOUTH CAROLINA | 15 | 15 | 9 | | |
| SOUTH DAKOTA | 13 | 13 | 11 | | L |
| TENNESSEE | 17 | 16 | 13 | | L |
| TEXAS | 15 | 15 | 11 | | |
| UTAH | 19 | 19 | 19 | | |
| VERMONT | 13 | 14 | 13 | | |
| VIRGINIA | 17.5 | 16 | 17.5 | | L |
| WASHINGTON | 18 | 18 | 16.2 | | |
| *WEST VIRGINIA | 15.35 | 15.35 | 15.35 | | |
| /*WISCONSIN | 20 | 20 | 20 | | |
| WYOMING | 8 | 8 | 8 | | |

* Variable tax expressed in cents per gallon.
See notes on reverse side for additional information.

/ Updated since last chart
Highway Users Federation
August 1, 1987

## NOTES

Alabama - Includes 2 cent "inspection fee" - Gasohol exemp. is off tax without inspection fee added.

Arizona - Motor fuel tax increases 1 cent on 7/1/90

Connecticut - Another 1 cent/gal to be added each July 1 through 1991

Florida - Variable: 4 cents + 5% retail average (5.7 cent floor on sales tax portion)

Delaware - 3 cent/gal. increase to Gasoline & Diesel 9/1/87.

Georgia - Plus 3% on retail price excluding state taxes

Hawaii - Diesel tax includes 1 cent/gal tax for highway use; gasohol is exempt from sales tax

Illinois - 4% sales tax on gasohol

Indiana - Plus 8 cents special fuels surcharge on commercial vehicles paid quarterly

Kansas - Variable: 10.5% of unwtd. average retail

Kentucky - Variable: 9% wholesale average + increase of 1 cent for each 2 cent decrease in wholesale price;surtax on trucks 5.2 cents/gal, paid via report

Louisiana - Motor fuel subject to 1% sales tax 7/1/86 - 6/30/88, (one year extension passed in 1986).

Massachusetts - Variable: 10% wholesale average

Michigan - Variable: Federal Operations & Maintenance Cost (FOMC) + consumption (2 cent max. per year)

Mississippi - Effective 7/1/87 removal of 6% sales tax on motor fuels as well as gasoline & Diesel tax increases: 7/1/87 6 cents/gal, 1/1/88 2 cents/gal, 1/1/89 1 cent/gal, thereafter, taxes revert to: Gasoline - 14.4 cents/gal,Diesel - 14.75 cents/gal

Nebraska - Variable: 12.5 cent base plus excise tax

Nevada - Gasoline tax increase 2 cents, diesel 3 cents 7/1/88.

New York - 4% sales tax; 2.75% gross earnings tax on oil co.

North Carolina - Includes 0.25 cent inspection fee.
Variable: Effective 7/15/86 increase of 2 cents plus 3% of wholesale average

Ohio - Variable: Effective 7/1/87 to be adjusted March 1 each year 1988 thru 1993. Ceiling on increase is .8 of one cent/gal. Calc. using maint. index factor & consumption of motor fuel.

Oklahoma - Includes 0.08 cent inspection fee

Oregon - Diesel taxed through ton-mile structure.Each January, 1988 - 1990, increase motor fuel tax by 2 cents/gal.

Pennsylvania - 6% is wholesale franchise tax; varies between 5.4 cents and 7.5 cents

Rhode Island - Variable: 11% wholesale average + excise tax equal to 2% of wholesale price

South Carolina - Motor fuel tax increases 1 cent 1/1/89.

South Dakota - Dealers blndg ethanol w/ gas recv. 1 cent/gal credit

Tennessee - Incl. 1 cent special petroleum tax for gas and diesel

Texas - Make temporary motor fuel tax increase enacted in 1986 permanent as of 9/1/87.

West Virginia - Variable: 10.5 cents + 5% wholesale average

Wisconsin - Variable: Federal Operations & Maintenance Cost plus consumption

Draft Testimony of Alain Carranza, Executive Director
Hispanic Federation of Illinois Chambers of Commerce
Submitted for the printed record to
the U.S Senate Finance Committee
August 14, 1987

Mr. Chairman and members of the committee, I am Alain Carranza, Executive Director of the Hispanic Federation of Illinois Chambers of Comerce, which comprises some 11,000 Hispanic businesses through the the state. Illinois has some 800,000 Hispanic residents, the fifth largest Hispanic populattion in the country.

I appreciate the opportunity to be here today representing the Federation on an issue of great concern to our members. That is, congressional proposals to raise excise taxes.

We realize the huge task facing the members of this committee as you seek to cut federal deficit. However, we urge you to focus on means other than regressive taxation to solve our budget problems.

Excise taxes fall hardest on those least able to bear the burden-- the poor and minorities. Numbered among those who will be disproportionately affected are Hispanics, who suffer from high rates of poverty and unemployment.

Currently, one in three Hispanics lives on poverty. While Hispanics make up only 10 percent of this nation's children, they comprise 20 percent of the poor children.

As I am sure the committee is aware, according to a recent Congressional Budget Office study, excise tax rates as a percentage of income are as much as 15 times higher for low-income families than for wealthier households. For these families, who live in tight budgets, increases in the prices of everyday goods, such as gasoline, beer and cigarettes, can pose atrue hardship.

Hispanic businesses are especially hard hit by excise taxes. Most Hispanic businesses are small and operate on a slim margin. Excise taxes must be passed on to consumers in the form of higher priced goods. The resulting loss in sales and profits can cause a ripple effect in the surrounding community as businesses close, workers are laid off and have less income to spend in other local establishments. At very least, businesses wind up with less capital available to invest in wages and service improvements.

In a broader sense, excise taxes constitute unwarranted meddling in the marketplace, arbitrarily discriminating against consumers and producers of selected goods and services.

Perhaps the damage done by excise taxes would not be so striking if the benefits were not so limited by comparison. In exchange for the harm to consumers, businesses and the communities they support, excise taxes yield only a drop in the bucket toward erasing the balloning crisis of federal debt.

Mr. Chairman, the Hispanic Federation of Illinois Chambers of Commerce supports efforts to reduce the federal deficit. But this worthy goal should not be accomplished on the backs of the working poor, Hispanics and other minority groups.

Thank you.

# STATEMENT
# of the
# INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION
# on the
# COLLECTION OF FEDERAL GASOLINE EXCISE TAXES

## EXECUTIVE SUMMARY

The Independent Fuel Terminal Operators Association ("IFTOA") strongly supports the revenue proposal to move the collection point for Federal gasoline excise taxes up to the top of the petroleum distribution system.

During the past several years, there has been substantial gasoline tax evasion. Last July, the Subcommittee on Oversight of the House Committee on Ways and Means held a hearing to determine the magnitude of the problem. Estimates of lost revenue to the Federal Government ranged from about $200 million to $1 billion annually.

To address this problem, the Tax Reform Act of 1986 (P.L. 99-514) moved the point of collection of the tax, effective January 1, 1988, "up stream" to the refiner, importer or terminal operator. The Treasury Department plans to issue proposed regulations to implement this provision in the near future. It appears that those regulations will, in most instances, make removal from the terminal the taxable event.

IFTOA believes that deferring tax collection to the point of removal from the terminal does not satisfactorily correct collection abuses; rather, it continues to provide marketers with significant opportunities to avoid the payment of the tax, and may even have the unintended result of actually increasing the evasion. To implement Congressional intent and avoid tax evasion, IFTOA recommends that Congress adopt the collection amendment proposed in the Description of Options. It should include the following elements:

1. Tax is imposed upon the removal of gasoline from the refinery; it is paid and collected by the refiner.

2. Tax is imposed at the port of entry when it enters the United States; it is paid by the importer of record and collected by the U.S. Customs Service.

3. To prevent any refiner or terminal operator from obtaining a competitive advantage by holding the collected taxes, remittance to the Federal Government would be required every week. However, the filing requirement of a quarterly tax return would not be changed.

Accordingly, the Independent Fuel Terminal Operators Association urges that Section 4081 of the Internal Revenue Code be amended to permit the imposition and collection of the federal gasoline excise tax at the earliest point of distribution. Such a measure would minimize tax evasion and bring substantial additional revenue annually to the Federal Government even at the current tax rates. This proposed method of collection would more efficiently implement the objectives of the section originally adopted by the Congress as part of the Tax Reform Act last fall.

Mr. Chairman:

I am Joseph J. Ackell, a Senior Vice President and Chief Legal Officer of Northville Industries Corp. of Melville, New York. Northville is an independent marketer and trader of refined petroleum products principally in the Mid-Atlantic states; we operate several deepwater terminals in New York and New Jersey with approximately 11 million barrels of storage capacity.

I am appearing today on behalf of the Independent Fuel Terminal Operators Association ("IFTOA"). IFTOA strongly supports the Joint Committee proposal to move the collection point for federal gasoline excise taxes to the top of the petroleum distribution system. This revenue option appeared in the "Description of Possible Options to Increase Revenues prepared for the Committee on Ways and Means" by the staffs of the Joint Committee on Taxation and the Committee on Ways and Means.1/ It simply builds on the efforts of the Congress in the last session to eliminate gasoline tax evasion.

IFTOA is composed of 19 companies which operate 57 deepwater and 42 barge oil terminals along the East Coast from Maine to Florida.2/ None is affiliated with a major oil company. Members are primarily marketers of residual fuel oils (Nos. 4, 5 and 6 fuels) and home heating oil (No. 2 fuel); several companies

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1/ U.S. Government Printing Office, "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means" at 66 (June 25, 1987).

2/ A list of members and a description of the Association is attached. (Attachment A).

also market significant volumes of gasoline at wholesale and retail levels. Members handle nearly 50% of the non-utility residual fuel oil shipped to the East Coast, nearly 60% of the non-utility residual fuel oil shipped to New England, 25% of the No. 2 heating oil shipped to the East Coast, and nearly 50% of the No. 2 heating oil shipped to New England.

## I. Current Law

Current federal law provides for a tax of 9.1 cents per gallon on motor gasoline. Section 4081 of the Internal Revenue Code. The tax is designed to be imposed at the manufacturer's level; however, in many situations the tax may be deferred to the end of the distribution chain through tax-exempt transfers. Thus, the tax is generally collected and remitted to the Internal Revenue Service by either the distributor selling gasoline to the retail marketer or the retail marketer.

Unfortunately, this system of deferral has resulted in substantial tax evasion. Firms have engaged in complex transactions to obscure recognition of the taxable entity, including but not limited to "daisy chain" operations; in these transactions companies operating with invalid tax exempt certificates purchase gasoline and resell the product many times in paper transactions.[3]

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[3] Numerous bogus or "shell" corporations have been able to obtain tax exempt certificates. In other cases, otherwise legitimate firms hold forged or cancelled certificates. Because the Federal Government does not maintain a centralized
(footnote continued)

Last July, the Subcommittee on Oversight of the House Committee on Ways and Means held a hearing to determine the magnitude of the problem. Treasury officials estimated the loss of revenue to the Federal Government from such evasion to be about $200 million annually. A private consulting firm, National Economic Research Associates, Inc., published a report this January placing the loss at more than $500 million; the Federal Bureau of Investigation testified last summer and more recently stated its conclusion that gasoline tax evasion costs the government as much as $800 million per year.4/ Finally, a gasoline marketer, who had been involved in elaborate tax evasion schemes in New York, testified that the loss was closer to $1 billion annually. These amounts represent significant losses to the Federal Government.5/

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(footnote continued from previous page)
list of tax exempt certificates, it is not possible for distributors who deal with such firms to verify the validity of a certificate presented to them.

4/ Pasztor, Andy and Gutfeld, Rose The Wall Street Journal, "Fuel Fraud," p. 1 (February 6, 1987).

5/ Tax evasion not only deprives Federal and state governments of taxes owed; it also places legitimate businessmen at a substantial competitive disadvantage. For example, in the State of New York federal and state gasoline taxes total about 30 cents per gallon. If a company is able to avoid paying that tax liability, it can undersell honest businessmen by a substantial amount and greatly diminish their market share. The consumer may benefit from this initial dishonesty through lower gasoline prices; however, the consumer will ultimately pay higher taxes in other contexts to compensate for the loss of gasoline tax revenues.

## II. Tax Reform Act

To address this problem, the Tax Reform Act of 1986 (P.L. 99-514) moved the point of collection of the tax, effective January 1, 1988, "up stream" to the refiner, importer or terminal operator. Specifically, the law provides:

1. if a refiner or an importer (a non-terminal operator) removes oil from a facility or sells it, without transferring the oil in bulk to a terminal operator, the refiner or importer will collect the tax;

2. a bulk transfer of gasoline from a refiner or importer to a terminal operator is not considered a removal or sale; and

3. if a terminal operator receives gasoline, it collects the tax on the earlier of (a) the removal or (b) the sale of the gasoline.[6]

The Treasury Department plans to issue proposed regulations to implement this provision in the near future. It appears that those regulations will, in most instances, make removal from the terminal the taxable event.

## III. Proposed Revenue Option

IFTOA believes that deferring tax collection to the point of removal from the terminal does not satisfactorily correct collection abuses because it continues to provide marketers with significant opportunities to avoid the payment of the tax, and it may even have the unintended result of actually increasing the evasion. For example, once gasoline enters a terminal, particularly oil not owned by the terminal operator, it can be bought and sold many times over.[7] Such turnover makes it difficult to trace the ownership of the oil leaving the terminal and increases the likelihood that the tax will remain unpaid.

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[6] The law does not address the issue of how to handle shipments between terminals or exchanges.

To implement Congressional intent and avoid tax evasion, IFTOA recommends that Congress adopt the collection amendment proposed in the Description of Options. The amendment should include the following elements:

1. Domestic Gasoline

Tax is imposed upon the removal of gasoline from the refinery; it is paid and collected by the refiner.

2. Imported Gasoline

Tax is imposed at the port of entry when it enters the United States; it is paid by the importer of record and collected by the U.S. Customs Service.

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[7] In many instances importers of refined petroleum products do not own their own terminal and storage facilities. Thus, they retain the services of a terminal operator to perform the function of unloading the vessel and placing the oil in storage for subsequent distribution. For these services they pay a terminalling fee. In these instances the importer, not the terminal operator, holds title to the product.

3. Remittance

To prevent any refiner or terminal operator from obtaining a competitive advantage by holding the collected taxes, remittance to the Federal Government would be required every week. However, the filing requirement of a quarterly tax return would not be changed.

## IV. The Float

Gasoline distributors who purchase product from refiners or terminal operators have been advocating that they serve as collectors of the tax. Their objective is to hold the money for a limited time prior to remittance. During this time, these distributors would have use of the funds; they could either deposit the money in an interest-bearing account or use the funds to reduce working capital requirements. The "float", the term used to describe the holding of the collected tax revenues, is beneficial because it provides a marketer with extra working capital. Currently, these distributors oppose the move of the tax collection point to the refiner or terminal operator because they would like to retain the float which they believe to be significant.

In 1985, the National Economic Research Associates, Inc., a private economic consulting firm, analyzed and quantified the float earned by New York distributors on collection of state taxes.[8] NERA determined that the float was far less significant than originally thought and ranged from $100 to about $500 per month for each distributor. Thus, it was not an essential source of income for such distributors. An analysis of the value of the float based on the collection of federal taxes is likely to produce a similar conclusion.

Moreover, placing the point of collection further down the distribution chain to provide certain marketers with the "float" undermines the purpose of the law -- to eliminate or at least substantially reduce tax evasion. Any benefits from the float are far outweighted by the threat of greater fraud and tax evasion.[9]

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[8] Evasion of gasoline excise taxes has been a significant problem in New york during the prior five years.

[9] Prior to 1982, New York collected its state and local gasoline taxes from gasoline retailers. This method proved to be burdensome; the large number of retailers (about 10,000) and their rapid turnover made administration and enforcement difficult. In an attempt to deal with this problem, New York State passed legislation in 1982 to collect these taxes from distributors, rather than retailers (as is now being proposed by the distributors), because there are only about 400 distributors statewide; it was thought that collecting taxes at this level would be easier to administer and enforce.

Unfortunatley, the legislation had the unintended effect of increasing significantly the financial incentives for gasoline tax evasion. Because the volume of gasoline handled by the average distributor was much greater than that handled by the average retailer, the amount of taxes to be paid by individual distributors was correspondingly larger. To evade these taxes, a variety of schemes was invented to sell gasoline without reporting the taxes to the State. Beginning in the last quarter of 1982, there was an upsurge in

(footnote continued)

## V. Increased Taxes

At present there is much discussion in Congress about increasing the federal gasoline excise tax. For example, a revenue proposal to increase the tax by 5 or 10 cents per gallon appears in the Revenue Options booklet.[10] Assuming such a proposal is enacted, there will be substantially greater monetary incentive for tax evasion.

## VI. Conclusion

Accordingly, the Independent Fuel Terminal Operators Association urges that Section 4081 of the Internal Revenue Code be amended to permit the imposition and collection of the federal gasoline excise tax at the earliest point of distribution. Such a measure would minimize tax evasion and bring substantial additional revenue annually to the Federal Government even at current tax rates. This proposed method of collection would more efficiently implement the objectives of the section originally adopted by the Congress as part of the Tax Reform Act last fall.

Thank you very much.

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(footnote continued from previous page)
bootleg and other unreported gasoline sales; these sales resulted in lost tax revenues for the State and its localities and injured legitimate distributors who competed against dealers selling illegally low-priced gasoline. To correct the problem, in late 1985 New York moved the point of collection to the first import or sale. This change proved successful; in the first year following its implementation, the State of New York collected more than $160 million of additional revenue.

[10] U.S. Government Printing Office, "Description of Possible Options to Increase Revenues prepared for the Committee on Ways and Means" at 63 (June 25, 1987).

ATTACHMENT A

## MEMBERS

## INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION

Astroline Corporation
Saugus, Massachusetts

Atlantic Fuels Marketing Corp.
Montvale, New Jersey

Belcher Oil Company
Miami, Florida

Bray Terminals, Inc.
Albany, New York

Castle Coal & Oil Co., Inc.
Bronx, New York

Catamount Petroleum Corporation
Chelsea, Massachusetts

Colonial Oil Industries, Inc.
Savannah, Georgia

Global Petroleum Corp.
Waltham, Massachusetts

Gulf Oil-Cumberland Farms
Canton, Massachusetts

Meenan Oil Co., Inc.
Syosset, New York

Northeast Petroleum Division
of Cargill, Incorporated
Chelsea, Massachusetts

Northville Industries Corp.
Melville, New York

Quinoil Industries, Inc.
Quincy, Massachusetts

C.H. Sprague & Son Company
Boston, Massachusetts

Steuart Petroleum Company
Piney Point, Maryland

Swann Oil, Inc.
Philadelphia, Pennsylvania

Webber Tanks, Inc.
Bucksport, Maine

Whaleco
Brooklyn, New York

Wyatt, Inc.
New Haven, Connecticut

The 19 companies listed above own and control terminals capable of receiving ocean-going tankers. None is affiliated with a major integrated oil company. Members of the Association are independent marketers of home heating oil (No. 2 fuel), residual fuel oils (Nos. 4, 5 and 6 fuels), gasoline and other petroleum products.

They distribute more than 50% of the No. 2 fuel oil consumed in New England and nearly 25% of the No. 2 fuel oil consumed along the East Coast. They distribute nearly 60% of the residual fuel oil burned by non-utility consumers in New England and nearly 50% on the East Coast.

The 19 companies own and control 57 deepwater terminals and 42 barge terminals, with a total storage capacity of over 58 million barrels. Of the total, about 26 million barrels are for No. 2 fuel oil, about 24 million barrels are for residual fuel oil, and about 7.4 million barrels are for gasoline and other products.

INTERNATIONAL TRADE COUNCIL
750 Thirteenth Street, S.E., Washington, D.C. 20003 U.S.A.
Telephone: (202) 547-1727

COMMITTEE ON FINANCE
UNITED STATES SENATE

HEARINGS ON BUDGET RESOLUTION

JULY 18, 1987

Mr. Chairman and members of the Committee. I am Dr. Peter T. Nelsen. I am an economist and President of the International Trade Council. ITC is a trade Association that represents producers of U.S. products, commodities and services in 49 of the 50 states.

The budget resolution passed by Congress instructs the Finance Committee to report legislation raising $19.3 billion in new revenue for fiscal year 1988.

Any type or form of tax increase at this time might very probably drive our fragile economy into a recession which would cause thousands of Americans to lose their jobs and in turn reduce tax revenue to the government.

ITC herewith presents a positive alternative which will eliminate the need for additional taxes and enable us to spend within the limits of the Gramm-Rudman Act.

## Federal Debt Reduction Proposal

The International Trade Council and the International Development Institute have jointly conducted a thorough economic policy study on the possible solutions to the three major interrelated problems that face the United States economy and which have a profound effect on the free world economy.

These problems are:

(1) the growing national debt;

(2) the growing annual budget deficit; and

(3) the foreign trade deficit.

The Federal Debt Reduction Proposal is designed to effectively address these problems.

The national debt has accumulated to a figure of about $2 trillion. Interest on this debt has risen to almost $150 billion in 1986, while the annual federal budget deficit has been running in excess of $200 billion. Continuation of these current deficits and interest rates for another five years would lead to a $3 trillion debt and interest payments of nearly $200 billion. (See Appendix A.)

The federal government has attempted to deal with this deficit by financing the federal budget deficit in two ways:

(1) by increasing the money supply; and

(2) by borrowing in credit markets.

The increases in the money supply, ranging from 9% to 12% have not been adequate to avoid the latter practice of borrowing heavily in credit markets, both home and abroad.

This heavy borrowing has until recently created higher and higher real interest rates which attracts foreign investors to the U.S. dollar and thereby strengthens the dollar. (The IDI proposal would largely substitute new U.S. money for foreign investment.) The recent drop in the dollar has not yet caused a decline in the foreign investment. Therefore, the price of U.S. products have been more expensive and the 1986 trade deficit rose to $170 billion, and the current account deficit to $140 billion.

Clearly there is a need for prompt and effective action. The Gramm-Rudman-Hollings Act has mandated a reduction in government spending and reflects the intent of Congress and the electorate to address the three major problems.

The reduction in government spending by itself could have an adverse side effect in that it will serve to dampen the level of nominal growth in the Gross National Product (GNP) that occurred in 1986 and that is projected to continue through 1987. The present rate of growth is 2.3 percentum; this matches the rate of growth in the other industrialized countries and could be sustained if there are no adverse regulatory changes.

Some sectors of the public have demanded regulatory change in the form of increased taxes. This is seen as an alternative to further cutting social programs. However, this would compound the shock to the economy that decreased government spending would impose and the likely result, coupled with the inflationary effect on the falling dollar, would cause a recession in 1987 or 1988.

Any reduction in the growth of GNP would also increase unemployment which would trigger a downturn by perception regardless of the economic reality and thus push the country further toward a recession.

These alternatives are unacceptable; therefore, IDI has formulated a proposal that will allow the federal debt to be retired over 10 to 15 years with minimal risk of inflation or recession.

## Proposal

It is proposed herewith that a change in monetary policy to be adopted, to-wit: the Treasury and the United States Federal Reserve Board (FRB) would change its method of increasing the money supply. The FRB will infuse new money into the economy to payoff debt notes (Government Bonds) as they become due in an amount of not less than the planned increase in the annual money supply (growth in GNP plus inflation plus FRB planned increase, recently totaling approximately 10%), and not more than the amount of the foreign trade deficit, i.e., between $100 and $170 billion for 1986, to be applied in 1987. This will enable the federal government to reduce borrowing money from major Wall Street lenders for this purpose.

This method would be substituted for the way the money supply is presently increased by foreign investment and by the FRB through discount loans to banks, etc. By placing the new funds into circulation in payment of bonds due, or by using the funds to pay other government expenses, the funds will in turn go into the private sector economy and into the banks.

The present system of borrowing on Wall Street by selling federal notes and bonds is highly inflationary. When federal notes and bonds are sold at 5-8% yield with no risk to the purchaser, they are equal in value to private sector financial instruments yielding 10-12%. This sets an artificial floor for private sector investment and capital expansion since it is difficult for private investors to justify investments that would not yield more than that of government paper.

In order to make the proposal politically acceptable, the following three conditions would have to be imposed:

(1) the amount of new money to be issued would be up to but not above the current year's foreign trade deficit; i.e., the amount that has left the domestic economy in overseas payment of imports;

(2) the funds could only be used to payoff current or existing principal debts;

(3) the laws and regulations implementing this proposal would expire when the national debt is eliminated.

This proposal does not suggest increasing the money supply in M1 or M2. Rather the FRB will issue new money credits to pay off federal notes, bonds and approved budget expenditures when they become due, and curtail the increasing money supply by giving less credits to lending institutions at the federal discount rate and thus avoiding the artificial floor for interest rates in the private sector. Past purchasers of government bonds would reinvest their proceeds in industry bonds and commercial investments thus funding productivity and employment. They would not be inclined to leave their money in M1 or M2.

## Historical Background

In recent years the United States has had a loose fiscal policy with increasing deficits and a tight monetary policy. There now exists a unique accord between the President, both parties in Congress and a recognition by the voting public that the federal debt, current budget debt and the trade deficit must be corrected. We are, therefore, with Gramm-Rudman-Hollings changing 180 degrees, moving toward a tight fiscal policy and a relaxed monetary policy; thus, keeping the present interest rates in order to expand the economy.

Issuing new money has always been one of the tools with which the Treasury and the Federal Reserve Board has controlled the economy. Other methods have included adjusting the discount rate and changing reserve requirement for banks.

Foreign investment has substantially increased the money supply. The lack of control by the U.S. of the possible sudden withdrawal of large amounts of those funds have become an item of concern to the U.S.

There have been times when the national budget deficits were covered by the printing of new money. More recently, deficits have been covered by selling government bonds on Wall Street. Both methods are characteristically inflationary to the same extent, i.e., both methods have traditionally caused the same risk of inflation.

The amount paid to interest on the national debt has been the fastest growing item in recent federal budgets (presently 15.5%). These interest payments have increasingly been paid to people and institutions outside of the United States.

The unprecedented rise in the trade deficit since the beginning of 1983, together with the rise in the world price of the United States money, has created an unprecedented scenario caused primarily by the perception around the world that the United States is a "safe haven" for investment in a sea of instability on other parts of the world.

While the influx of foreign investment has been of some benefit to the U.S. economy in the short run, it cannot be relied upon to assure a healthy, stable economy in the long run. Monies invested here from other countries would bring greater benefit to our economy if those funds were invested in their home economies thus strengthening and stabilizing those nations and creating strong partners with which to trade.

If "all" investment capital would come to the United States in the form of investment, there would be a scenario like a monopoly game where one player wins all of the resources and all the other players lose. The objective in international economics must be to keep the "game" going with as many liquid players as possible.

## Analysis of Proposal

The Debt Reduction Proposal would have the following beneficial effects:

(1) the market demand for the U.S. dollar would decrease; therefore, would the price of the U.S. dollar. This will make it easier for U.S. producers to compete in the world market and the trend of the trade deficit will be reversed;

(2) foreign capital would more likely be invested in its domestic economy which would create market opportunities for U.S. producers, both for export of capital equipment and for consumer goods sought by the workers employed there;

(3) geopolitical stability would be enhanced in approximately 100 "non-aligned" countries which are teetering between Communist rule and democracy. The success of the free enterprise opportunities would prove to be the best antidote to the spread of controlled, maxists-inspired economies;

(4) decreased demand for investment in government securities will free up capital for other investment and thus eliminate the artificial floor and drive down the "real interest rate;"

(5) the Debt Reduction Proposal is "inflation neutral"

because when "X" dollars worth of goods are purchased abroad, the dollars that are paid are credited to foreign accounts in payment thereof; therefore, an infusion in M3 and M4 will not change the amount of money in circulation. Those dollars stay or return to the U.S. as investment capital or to purchase U.S. exports and thereby benefit the U.S. economy;

(6) the Debt Reduction Proposal is "revenue positive" in that if the demand for government bonds and notes is reduced, that capital will flow to private sector investment which will create increased productivity and greater taxable earnings to the investor and jobs;

(7) the Federal Reserve Board would retain numerous methods of controlling the money supply, i.e., adjusting the discount rate, changing reserve requirements of the banks, etc.;

(8) the U.S. free enterprise system depends on expanding markets to attract investment capital. It is, therefore, essential that trading partners are developed overseas and that there is investment in expanded productivity at home so that the U.S. can more effectively compete in the world market place and develop a comparative advantage in the world wide economy;

(9) the Debt Reduction Proposal would have no effect upon the net worth of American resources since we substantially owe the money to ourselves (the same analysis does not apply to countries who owe the U.S. economy debt payable in dollars);

(10) the Debt Reduction Proposal will make the U.S. economy healthier thereby reducing pressure from sectors demanding protectionist measures. Such measures are not in the U.S. consumers' interest and would make it more difficult for U.S. producers to export.

(11) At this time it is important to give the economy time to adjust to the lower valued dollar which should bring about an increase in exports of 3% and a reduction in imports of about 1%, thus narrowing the trade gap and justifying a postponement of any thought of protectionist legislation. Any further effort to drop the value of the dollar would be highly inflationary and should be opposed for the rest of 1987. The immediate task should be to help U.S. producers become more competitive in the world market by regulatory reform and inducement for thousands of U.S. producers to enter the export market through cooperative world marketing and distribution efforts, such as the U.S. International TradeCenter system sponsored by ITC and IDI.

(12) The substitution of U.S. treasury funds for foreign capital will reduce the U.S. foreign debt which last year made the U.S. the largest debtor nation in the world.

## Conclusion

The Debt Reduction Proposal will assist the future implementation of the Gramm-Rudman-Hollings Act with minimized risk of undue shock to the U.S. economy and eliminate the need for new taxes.

The implementation of the Debt Reduction Proposal will free up investment capital that can be invested in productive enterprise, thereby permitting U.S. producers to compete more effectively in the world market and over time increases U.S. exports to match our imports.

The proposal is no cure or excuse for deficit spending, but the temporary implementation of the proposed change, together with a concurrent provision to avoid increases in the size of the annual Federal budget, until federal revenue receipts, increased by inflation and growth in G.N.P., equals the annual budget expenditures -- will balance the budget within eight to ten years.

## STATEMENT OF

## THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

My name is Wallace R. Woodbury. I am Chairman of the Board of Woodbury Corporation, Salt Lake City, Utah, a long-established real estate development, brokerage, management and consulting firm. I am also Chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I submit this testimony today on behalf of the members of ICSC.

The International Council of Shopping Centers is the trade association for the shopping center industry with over 21,000 members. Membership includes developers, owners, retailers, lenders and all others having a professional interest in the shopping center industry. ICSC members represent most of the 28,500 shopping centers in the United States. In 1986 these centers generated $20.3 billion in sales tax revenues and employed 6.9 million people.

The "Description of Possible Options to Increase Revenues" prepared by the staff of the Joint Committee on Taxation contains numerous provisions that concern the members of ICSC. The real estate and shopping center industries are concerned that many of the proposals would inappropriately reduce investment in real estate and decrease the ability of shopping centers and retailers to adequately serve the needs of consumers. It is important that the consequences to the shopping center industry of future tax policy changes contained in the proposals be carefully considered.

### (1) VALUE ADDED TAX

#### Proposal

Present law does not provide for a federal sales tax. The proposal imposes a new value added tax (VAT) which is the economic equivalent of a tax at each stage of production. A value added tax is a sales tax imposed on the value added to goods and services by each business.

Two types of VATs are proposed. The first is modeled after the VAT used in Europe whereby each business calculates the tax based on its sales and is permitted a credit for the VAT already imposed on its purchases. The second type is referred to as a business alternative minimum tax (BAMT). This tax is imposed on the difference between a business' receipts and expenses. Under the BAMT, deductions are granted for the employer-paid portion of the social security tax (FICA), one-half of a self-employed individual's social security tax (SECA) and a business' net operating losses.

### ICSC Position

ICSC opposes the imposition of a value added tax. Shopping centers account for more than one-half of the retail sales in the U.S. (excluding automobile sales). As the proposal states, a VAT is the "economic equivalent of a retail sales tax," and a 5% VAT would approximately double the sales tax imposed by most states. This would reduce retail sales, adversely affecting employment and the economy generally and shopping centers in particular, and ultimately reducing the federal tax revenues.

Another defect of a VAT is that, like all sales taxes, it is regressive. It also would establish a completely new system of federal taxation, and would impinge on a source of revenue that has traditionally been reserved to the states.

## (2) REDUCTION IN INDIVIDUAL AND CORPORATE TAX PREFERENCES

### Proposal

Exclusions, credits, deductions, and deferrals of tax liability provide economic incentives to the private sector, tax relief to certain taxpayers, and are necessary to measure the "net" income to which the federal tax applies. The pamphlet proposes to reduce certain of these "preferences" by either 10% or 20% for purposes of both the regular income tax and the alternative minimum tax "AMT." Items of deferral (e.g., accelerated depreciation) would be permitted only to the extent of a certain percentage of the item involved. Among the preference items cited for possible percentage reduction are "accelerated" depreciation, itemized deductions for individuals, ITC, business and travel expenses. The description also proposes to increase the AMT rate.

### ICSC Position

ICSC opposes the proposed reductions in certain tax preferences. Congress has eschewed a gross income tax for the reason that gross income does not realistically measure real income. The production of income necessarily involves expenditures on the part of taxpayers, and these expenditures should be fully accounted for in measuring taxable income.

Reducing depreciation deductions by 10% further exacerbates the insufficient 31.5 year straight-line recovery period for non-residential real property. Denying taxpayers 10% of their depreciation deduction effectively extends the recovery period for non-residential real property to 35 years while a 1973 study of actual depreciation rates of shopping centers showed an average life of 25 years with a range of 22 to 29 years. Other legitimate expenses that are incurred for the production of income, such as travel costs, also would be inappropriately limited. The current AMT already prevents taxpayers from taking full advantage of certain tax preferences.

## (3) LIMITATIONS ON THE DEDUCTIBILITY OF ADVERTISING COSTS

### Proposal

The proposal would treat advertising expenses not as ordinary and necessary business expenses that are currently deductible, but rather as capital expenditures that must be amortized, at least in part, over a period of years. The proposal would require 4-year amortization of 20% of advertising expenditures or, for firms with over $5 million in gross receipts, permanently deny a deduction for 20% of the expenditures and require the remaining 80% to be amortized over 2 years.

### ICSC Position

ICSC opposes any limitations on the deductibility of advertising expenses. Such limitations will discourage advertising, resulting in a reduction in sales and a consequent ultimate diminution of federal and state tax revenues.

Shopping centers have been economic successes primarily because many businesses compete to provide the best and least expensive goods and services, in close proximity to one another, strongly facilitating the benefits of a free market economy to consumers. Businesses advertise to inform customers of the way they compete in providing their goods and services. A reduction in advertising will result in a reduction of competition.

In addition, shopping centers are major locations for new and small businesses due to the availability and relative affordability of retail space. These businesses rely heavily on advertising to establish themselves as viable entitites in the market. New businesses necessarily advertise heavily in their first year need to deduct this expense in that year in order to avoid financial hardships. This proposal would be particularly unfair to small business because it would act as an impediment to the success of smaller, lesser-known enterprises.

Congress should also be aware that all advertising expenditures are not for the same purpose and do not produce the same benefits. Price advertisements that announce short-term sales or product availability attempt to match buyers with sellers and establish supply-demand adjustments in the short-run. Such advertisements are heavily used by retailers in shopping centers, have short-term impact, and should be currently deductible.

## (4) INSTALLMENT SALES

Proposal

Under present law, enacted last year by the Tax Reform Act, dealer sales of real property and sales of real property for over $150,000 (which includes virtually all shopping centers) used in the taxpayer's trade or business or held for the production income are subject to the "proportionate disallowance rule." This rule requires the taxpayer to treat a portion of the installment obligation calculated by a complicated formula (the amount of the obligation multiplied by his total debt to asset ratio) as a payment on the installment obligation.

The proposal would completely repeal installment sales treatment for taxpayers subject to the proportionate disallowance rule as well as for all sales by dealers.

ICSC Position

ICSC opposes the installment sales proposal and urges Congress instead to repeal the installment sales provisions of the Tax Reform Act of 1986 (TRA '86).

The installment sales rules were originally enacted to ensure that sellers pay tax on sales proceeds only as the proceeds were received. Congress recognized that taxpayers engaging in installment sales may lack the liquidity to pay the tax on the entire gain from the sale. TRA '86 essentially repealed the tax benefits from the installment sales rules for many taxpayers. The proportionate disallowance rule is a significant restriction on installment sales and fails to accurately measure income for tax purposes or any other financial purpose.

Non-dealers in commercial real estate and business property should be subject to the installment sales rules of prior law which would allow them to treat installment sales payments as income only when those payments are received. It is unreasonable to create a situation where the tax liability in the year of a sale may exceed the cash received by the seller in the transaction. This change would reestablish seller financing as an available method of selling business and investment property, a method that often is the only means available, particularly in periods of high interest rates. Installment sales are traditionally used by new entrants in the shopping center business that find it difficult or impossible to obtain commercial financing. Since businesses involving substantial real estate operations traditionally have large amounts of debt in relation to assets, individuals involved in the sale of shopping centers are unfairly burdened by the proportionate disallowance rule, penalizing taxpayers because of extrinsic debt totally unrelated to the transaction.

Because installment sales treatment does not eliminate ultimate tax liability, neither the TRA '86 changes nor the reinstatement of pre-TRA '86 law affect the total amount of tax paid. The timing of the payment of that tax is important, however, and it is unfair to require the payment on a tax in excess of the cash received on a sale. Inability to pay the tax in many cases will prevent the sale and reduce federal revenues.

## (5) PARTNERSHIP PROVISIONS

### Proposals

Master limited partnerships ("MLPs") are limited partnerships the interests of which are publicly traded or offered. MLPs are classified as partnerships pursuant to the characteristics set forth in the Treasury regulations distinguishing partnerships from corporations. One proposal would treat MLPs as corporations for federal tax purposes. Another proposal would treat MLPs and all limited partnerships as corporations for AMT purposes but not for regular income tax purposes. In addition, net income from MLPs would be deemed portfolio income rather than passive income, and MLPs would be prevented from passing through tax losses, deductions or credits to limited partners.

Another proposal would prevent the pass-through of tax losses, deductions or credits to limited partners in all limited partnerships. Net income would be taxed only at the partner level, and would be classified as portfolio rather than passive income in the hands of the partners.

### ICSC Position

ICSC opposes these proposals to radically alter the taxation of partnerships and has submitted more detailed testimony explaining the reasons for it's opposition to the Committee in regard to the hearings on MLPs.

However, in summary, ICSC believes the master limited partnership and limited partnership provisions would inhibit new shopping center development and investment in risky development, misstate a partner's real income by disregarding certain losses, and discourage small business start-up. Taxing real estate MLPs as corporations will cause double taxation and significantly reduce yields to investors causing an outflow of capital from such investments. Rental real estate losses should not be deemed passive while income from such properties will be classified as protfolio income.

## (6) RECOVERY PERIOD DETERMINED BY REFERENCE TO 125% OF LEASE TERM

### Proposal

The present tax law assigns recovery periods to property for depreciation purposes. The proposal would provide special recovery periods for leased property, equal to the longer of 125% of the lease term (including renewal options) or the recovery period otherwise applicable.

### ICSC Position

ICSC opposes establishing recovery periods for leased property by reference to the term of the lease. The proposal ignores the fact that the true economic life of an asset remains the same whether it is owned or leased. This will result in substantially different recovery periods for identical properties. The negotiated duration and price of shopping center leases considers not only the use of the structure but also the long-term acquisition of an attractive commercial location and the long-term business relationship among shopping center tenants.

Long-term shopping center leases involving major retailers confer residual value to both the tenant and the lessor. Inducing a major retailer to join a shopping center enables the lessor to more readily attract commercial financing as well as smaller tenants.

The major retailer, on the other hand, seeks to secure an attractive business location for an extended period. Any renewal options included in the lease represent a retailer's desire to preserve its location and participation in the successful "tenant mix" created by the developer to attract shoppers to the center. The lease also gives the major retailer the option to abandon unsuccessful sites at a minimum cost.

An option to renew is by nature unilateral. If by hindsight a tenant determines the option to have economic value, whether due to increased land value or interim remodeling and capital expenditures or otherwise, optionee will exercise without regard to whether the original improvement has any substantial residual value. Consequently, renewal options are not reflective of the economic life of improvements.

All long-term tenants in shopping centers expect that their facility will be substantially remodeled at least every 10 years. This remodeling is necessary in order for the retailer to compete effectively with businesses located in new, modern facilities and with others who remodel to remain competitive in attracting customers. Both parties envision that substantial reinvestment will be required on the roof, air conditioning, and elevator systems as they wear out, and in both the interior and the shell of the building in order to maintain the shopping center's commercial attractiveness. Thus, the renewal option is not a judgment by the tenant that the original structure will retain its value over that period, but an effort by the tenant to secure a desirable business location and commercial relationships over the long term. The lease term and options for renewal, therefore, do not bear any correlation to the commercially economic useful life of the structure.

Studies conducted for ICSC by Touche Ross indicate that the average useful life of a shopping center structure is 25 years with a range from 22 to 29 years. Therefore, the current recovery period of 31.5 straight-line years for nonresidential real estate is inadequate to allow the full recovery of the capital invested during the economic life of the improvements and imposes a tax on capital rather than income. These impacts would be exacerbated by establishing the recovery period by reference to a lease term and renewal options which bear no correlation to the structure's useful life and which could produce a depreciation period which far exceeds the real economic life of the property.

## (7) LIKE-KIND EXCHANGES

### Proposal

Present law provides that no gain or loss is recognized if property held for use in the taxpayer's trade or business (or property held for investment purposes) is exchanged solely for property of a like-kind that will also be held for business (or investment) purposes. Deferred exchanges may occur, subject to limitations, provided the exchange property be designated within 45 days and the exchange be completed within 180 days following the date of the original transfer.

The proposal would deny like-kind exchange treatment for real estate. Alternatively, the proposal would narrow the types of property that would qualify as like-kind for tax-deferred exchange by considering similar use of property rather than ownership classification. Another alternative proposal would require that all like-kind exchanges must be made simultaneously.

### ICSC Position

ICSC opposes the like-kind exchange proposals because they are inconsistent with basic tax policy considerations, are unfair to the real estate industry, would lock-in properties, and would substantially inhibit the flow of real estate capital.

Like-kind exchange nonrecognition treatment is justified because taxpayers remain in the same economic position after the exchange. The taxpayer has not changed the form of his investment or received cash. The non-taxable exchange of appreciated property for like-kind property also encourages the mobility of capital investment and has facilitated the development of real property.

The elimination of like-kind nonrecognition treatment for real estate will adversely impact a dynamic industry where successful developers and owners frequently enter into new real estate ventures via like-kind exchanges. The proposal would encourage taxpayers to refrain from disposing of appreciated real property in order to postpone taxation. Inhibiting the flow of real estate capital will result in fewer taxable transactions.

Real estate that is used in a taxpayer's trade or business or held for investment takes many different forms. For instance, shopping centers, industrial parks, office buildings, residential rental units, and undeveloped land may be involved with the same investment motivations. The ability to engage in a like-kind exchange with such properties often facilitates new economic development.

Another proposal would narrow the class of real property qualifying for nonrecognition under like-kind exchange provisions by extending the "similar or related in service or use" standard to such exchanges. This standard, for example, could be interpreted to prevent a nontaxable exchange of a shopping center for a mixed-use shopping center/office building, or to preclude the exchange of a small "strip" shopping center for a regional mall. Economically equivalent real estate is held in many different forms and the similar or related in service or use standard is too narrow for such property. This proposal would reinstate narrow criteria similar to those formerly, but no longer, applicable to reinvestment of condemnation proceeds.

## (8) INDIVIDUAL CAPITAL GAINS

### Proposal

The proposal would provide a maximum tax of 15% on net capital gains.

### ICSC Position

ICSC supports the proposal to reduce the capital gains tax rate for all taxpayers. This proposal would promote economic growth and essentially restore the capital gains tax to the effective rate that existed before TRA '86.

Prior to TRA '86, taxpayers paid a capital gains tax that in many cases ranged from 12% to 18%. This resulted from the fact that most taxpayers were not in the 50% tax bracket. Thus, for example, the 60% exclusion for long-term capital gains allowed taxpayers in the 40% tax bracket to pay a capital gains tax of approximately 16%. This proposal would effectively restore the capital gains tax rate to pre-1987 levels.

A lower tax rate for capital gains would encourage the sale of assets so that capital can flow to new enterprises and industry. Taxable transactions and, therefore, tax revenues also would increase as taxpayers would seek to realize the gain on their investments in light of the lower level of taxation. While some argue otherwise, the historical record seems to endorse ICSC's position that lowering the capital gains rate would, in fact, increase revenues by motivating substantially increased taxable transactions.

## (10) **ALTERNATIVE MINIMUM TAX**

### Proposal

The proposal would increase the alternative minimum tax (AMT) rate from 21% to 25%. In addition to the rate increase, the proposal would add a number of new preferences to the minimum tax.

### ICSC Position

ICSC opposes both an AMT rate increase and an expansion of the AMT preference items.

The AMT is an attempt to insure that taxpayers do not take undue advantage of deductions, credits, and losses permitted in the tax code in order to totally avoid paying income taxes. It is important to bear in mind, however, that the federal income tax does not tax "gross" income but rather permits deductions so that there is a tax on "net" income only. Expanding the number of tax "preferences" for purposes of the AMT serves to create a system that imposes a tax on gross rather than net income.

The proposal takes another large step in the direction of replacing the regular income tax with the AMT because of the proximity of the proposed 25 percent AMT rate and the 28 percent top regular tax rate. These changes will result in fewer taxpayers paying taxes under the regular tax system, and further distort the impact of regular tax deductions on taxpayer's basis in property.

Tax preferences are enacted by Congress to promote certain useful economic or social purposes. The incentives provided by these preferences will be undermined by an AMT rate increase.

## (11) REPEAL OF THE "STEPPED-UP BASIS" RULE

### Proposal

The basis of property acquired from a decedent is the fair market value of such property at the date of death. This is referred to as the "stepped-up basis" rule because survivors increase the basis of property by the amount of appreciation of the property while held by the decedent. Appreciated values are used in determining estate tax liability.

The proposal would impose an income tax on the net appreciation of a decedent's property passing upon his death. Property that passes to a spouse or charity, however, would not be subject to the appreciation tax but rather would receive a carryover basis equal to the decedent's basis.

### ICSC Position

ICSC opposes both the imposition of income tax on appreciation at death and repeal of the existing stepped-up basis rule.

The unit of taxation in this context should be the family and not the individual, and the death of the named owner should not trigger taxation. An income tax at death measured by appreciation would not only require unavailable liquidity in the estate, but would substantially increase the total taxes on assets passing from one generation to another, and preclude the continuation of many small businesses, including many family-run shopping center development and operation firms.

This proposal also would require taxpayers to maintain detailed and complicated records over long periods of time in order to accurately determine the bases of assets. Not only will taxpayers find this difficult and burdensome in the years ahead, but taxpayers do not have these records for property they currently own since there was no need to keep such records under existing law.

John Middleton
INCORPORATED
MANUFACTURERS OF FINE TOBACCOS SINCE 1856
KING OF PRUSSIA • PENNSYLVANIA • 19406

HERBERT H. MIDDLETON, JR.
PRESIDENT

August 6, 1987

Honorable Lloyd Bentsen
Senate Finance Committee
Suite 703, Hart Building
Washington, DC 20510

Dear Mr. Chairman:-

While we strongly oppose all the various options to increase the excise taxes on all tobacco products, we are most especially disturbed that a reinstatement of the federal excise tax on smoking tobacco might be considered among the options to reduce the deficit.

In 1918 the total domestic consumption of pipe tobacco in this country was 257,893,000 pounds. It had dropped to 205,101,000 by 1940 and to 95,366,000 pounds by 1950. To provide relief, Congress reduced the tax from 18¢ to 10¢.

Despite that, by 1965 the annual consumption of pipe tobacco in this country had dropped to 61,804,000 pounds. Congress then eliminated the tax entirely.

As documented by the attached chart, in the past ten years consumption of smoking tobacco has declined 56.9%. It has been off every year since 1984 by more than 10% per year and right now is running at 20.4% behind last year's first quarter results. Last year's total consumption of pipe tobacco for the United States fell to 20,576,000 pounds. Revenue that could be derived by the imposition of an excise tax at any rate imposed would be miniscule. For example, an option being considered by the House Ways and Means Committee would be an excise tax on smoking tobacco at the rate of 48¢ a pound. At the present rate of consumption, the annual tax yield based on that rate would be less than $10 million.

An excise tax on pipe tobacco could be the death knoll of an industry that would seem to be vanishing all by itself without any help from Congress.

Further, this regressive tax would impact adversely on people of lower income. A preponderance of pipe smokers are older people, many of whom are on pension.

Since the revenue that could be derived from an excise tax on smoking tobacco would be meaningless, a recommendation to reinstate such a tax could only be construed as punitive to a distressed industry and the consumers of its products. We trust the Committee in its wisdom will not recommend an excise tax on smoking tobacco.

Very truly yours,

Herbert H. Middleton, Jr.
President

HHM/ph
Enc.

## DOMESTIC AND IMPORT PIPE TOBACCO CONSUMPTION IN 1951, 1966 to 1986
### (in M Pounds)

| | Domestic | | Import | | Total | | Import % |
|---|---|---|---|---|---|---|---|
| Year | M Lbs. | % Chg | M Lbs. | % Chg | M Lbs. | % Chg | Share of Mkt. |
| 1950 | 93,302 | | 64 | | 95,366 | | |
| 1) 1951 | 88,834 | - 6.8 | 54 | -15.6 | 88,888 | - 6.8 | 0.001 |
| 1965 | 59,314 | -15.8 | 2,490 | -16.8 | 61,804 | -15.8 | 4.03 |
| 2) 1966 | 57,668 | - 2.8 | 3,268 | +31.2 | 60,936 | - 1.4 | 5.36 |
| 1967 | 55,295 | - 4.1 | 3,681 | +12.6 | 58,976 | - 3.2 | 6.66 |
| 1968 | 56,727 | + 2.6 | 5,609 | +52.4 | 62,336 | + 5.7 | 9.00 |
| 1969 | 55,616 | - 2.0 | 5,737 | + 2.3 | 61,353 | - 1.6 | 9.35 |
| 1970 | 54,699 | - 1.6 | 8,227 | +43.4 | 62,926 | + 2.6 | 13.07 |
| 1971 | 49,005 | -10.4 | 8,170 | - 0.7 | 57,175 | - 9.1 | 14.29 |
| 1972 | 45,548 | - 7.1 | 11,680 | +43.0 | 57,228 | + 0.1 | 20.41 |
| 1973 | 43,369 | - 4.8 | 7,841 | -32.9 | 51,210 | -10.5 | 15.31 |
| 1974 | 41,661 | - 3.9 | 9,945 | +26.8 | 51,606 | + 0.8 | 19.27 |
| 1975 | 38,869 | - 6.7 | 8,499 | -14.5 | 47,368 | - 8.2 | 17.94 |
| 1976 | 37,906 | - 2.5 | 9,881 | +16.3 | 47,787 | + 0.9 | 20.68 |
| 1977 | 35,216 | - 7.1 | 6,888 | -30.3 | 42,104 | -11.9 | 16.36 |
| 1978 | 31,400 | -10.8 | 8,877 | +28.9 | 40,277 | - 5.9 | 22.04 |
| 1979 | 28,820 | - 8.2 | 6,946 | -21.8 | 35,766 | -11.2 | 19.40 |
| 1980 | 27,319 | - 5.2 | 6,768 | - 2.6 | 34,087 | - 4.7 | 19.90 |
| 1981 | 26,774 | - 2.0 | 6,580 | - 2.8 | 33,354 | - 2.2 | 19.70 |
| 1982 | 24,527 | - 8.4 | 6,065 | - 7.8 | 30,592 | - 8.3 | 19.80 |
| 1983 | 22,975 | - 6.3 | 6,700 | +10.5 | 29,675 | - 3.0 | 22.60 |
| 1984 | 20,567 | -10.5 | 5,926 | -11.6 | 26,493 | -10.7 | 22.40 |
| 1985 | 18,091 | -12.0 | 5,378 | - 6.4 | 23,469 | -10.8 | 22.92 |
| 1986 | 15,623 | -13.6 | 4,953 | - 7.9 | 20,576 | -12.3 | 24.07 |

* First quarter 1987 shows total pounds - 20.4% from first quarter 1986.

Federal excise tax reduced: 1) 18¢/Lb. to 10¢ 2) 10¢/Lb. to 0.

## STATEMENT OF

### JOHN M. RICHMAN
### CHAIRMAN AND CHIEF EXECUTIVE OFFICER
### KRAFT, INC.

I am submitting this statement as chairman of the board and chief executive officer of Kraft, Inc. In addition, I am submitting a statement for the record on behalf of the CEO Tax Group, a group of corporations that very strongly supported and still supports the income tax reforms enacted last year -- and especially the lower tax rates under that law.

Over the course of the tax reform debate in 1985 and 1986, we were strong supporters of the tax reform effort. As I testified before the Senate Committee on Finance in 1985, "Only by removing numerous special interest provisions can we approach a more neutral, fairer, and simpler tax system. This would permit lower tax rates for individuals and corporations without a revenue loss."

We have our fairer, more neutral system and we have achieved simplification in some areas. Now, it's being suggested that deficit reduction should be achieved in part by attacking the cornerstone of that system -- the phased-in rate structure. Various options have been suggested. Among them:

1) Corporate and/or individual rate freezes.

2) Imposition of corporate and/or individual surtaxes.

3) Creation of a third rate bracket for high income individuals.

For the same basic reasons we vigorously supported tax reform, we strongly oppose any of these proposals. We believe that opening up the rate structure for deficit reduction will set a precedent for those who lost tax benefits during the creation of the Tax Reform Act of 1986 to come in and ask that their tax breaks be restored. Reform of our nation's tax system has been achieved. It should not now be lost before the nation can enjoy its full benefits.

The same valid arguments that we made in support of tax reform are just as strong today. Reducing rates, coupled with eliminating tax preference items, has produced a more level playing field. Before the enactment of the tax reform law, some very profitable corporations were paying little or no taxes, while other less profitable corporations were paying very close to the top corporate rate.

With the enactment of the Tax Reform Act of 1986, that disparity has been reduced so that more corporations with the same income pay about the same amount of tax.

Before the enactment of the Tax Reform Act of 1986, corporate and individual investment decisions often were based primarily on tax consequences, rather than on economic merit.

Since the enactment of TRA '86, businessmen and individuals are rediscovering the art of making business decisions for business reasons, rather than for tax reasons.

The CEO Tax Group was an early and consistent supporter of tax reform. One primary attraction of tax reform for the CEO Tax Group was Treasury I's proposed deduction for 50-percent of dividends paid. This proposal was later modified to a 10-percent deduction for dividends paid. The CEO Tax Group, nonetheless, continued their support for tax reform. The proposal for dividend deductibility was finally dropped. Still, the CEO Tax Group supported tax reform, as we do today.

The CEO Tax Group also supported tax reform while faced with the specter of higher taxes in the short term for some members. The CEO Tax Group supported tax reform despite the inevitability of a large shift of the tax burden from individuals to corporations. And when the final product was hammered out -- and $120 billion in tax burden was shifted from individuals to corporations -- the CEO Tax Group supported tax reform.

The CEO Tax Group believes that the Congress and the Administration made a compact with U.S. taxpayers -- both individuals and corporations -- that if taxpayers would give up many of their tax preferences, they would receive lower tax rates in return. We have given up most of our preferences, but the low rates that we traded for them are not effective yet.

Tax reform would not have been possible without a substantial reduction in the tax rates on individuals and corporations. Indeed, the attraction of low rates was the primary driving force behind the tax revision effort.

The CEO Tax Group urges this committee to leave the phased-in rate structure alone, so that its economic effects may be felt and individuals and the business community can assess its impact. Many corporations -- because of the way their fiscal years are set up -- have yet to feel the first reduction in the top marginal rate for corporations. And individuals across the nation have yet to feel the full effect of their substantially reduced rates, although they have already given up many of their preferences.

On the other side of the coin, the tax reform debate led to an examination of almost all of the preference items in the income tax code. Some preference items -- such as the home mortgage interest deduction -- were ruled "off the table" early in the process for political reasons.

We believe preference items considered during the debate -- both those that were dropped and those that were included in the final conference agreement --- should not be reconsidered in the current debate over deficit reduction. Such proposals underwent lengthy scrutiny over the past two years, and sound reasons for their inclusion -- or exclusion -- in current law became apparent during the course of that debate.

In addition, there have been four major tax bills over the last six years, and several other bills that would be counted as major were it not for the great breadth of the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984, and the landmark Tax Reform Act of 1986.

The reforms enacted in the Tax Reform Act of 1986 are etched in concrete, but the concrete needs more time to set, so that the effects of the reforms may be fully assessed and so that taxpayers -- businesses and individuals alike -- can feel that the tax code is a relatively stable part of the federal laws.

Without this sense of stability, taxpayers may decide to hedge their investments, betting on the return of tax preference items rather than making major commitments to long-term investments based on economic soundness.

The CEO Tax Group views the current budget deficits as one of the most serious problems facing the country today. We believe that tough choices must be made in order to reduce the deficit.

We further believe that spending cuts are more appropriate than revenue increases, and that Congress has not done all it can to control federal spending. As a chief executive officer, I have been faced over the past several years with a number of unappealing choices necessary to keep our companies vital and competitive. Other CEOs have faced the same choices at virtually every business in this country. And those choices have led to the elimination or substantial reduction of programs and departments within our companies that were considered necessary when they were established.

We appreciate, however, the fact that the Committee on Finance and the Committee on Ways and Means have been given binding instructions by Congress to raise $19.3 billion in new revenues for FY '88 and almost $65 billion in new revenues over three fiscal years. I personally believe that the amount is far too high, particularly because that amount falls so soon after large tax increases in 1982 and 1984 and, for much of America, as a result of the Tax Reform Act of 1986.

Let me note that after the Deficit Reduction Act of 1984 corporate America found itself barely in a better tax situation than it was prior to enactment of the Economic Recovery Tax Act in 1981. The Tax Reform Act of 1986 shifted at least another $120 billion from individuals on to corporate America. That may be the best argument I can make at this time for your committee to resist any further increases in corporate taxation.

As far as revenues are concerned, I personally believe that the time has come for a strong, concerted effort to crack down on noncompliance. The fact is that the previous tax structure of high rates and special preferences created an environment that encouraged both tax avoidance and noncompliance. The new structure of low rates and fewer preferences creates an unusual opportunity to bring about a new climate for compliance -- and, in all likelihood, to raise substantial new revenue in the process.

One proposal that addresses this problem would attack the underground economy and the "tax gap" problems. The proposal would raise new revenues and, at the same time, improve the administration of the tax code.

We hope this committee will not consider a rate increase as a means of deficit reduction. Such an increase would reopen the Pandora's box that members of this committee managed to nail shut last year: the Pandora's box of special tax preferences for special interests, to be paid for by higher rates. As your panel considers its reconciliation instructions, I hope you will protect the high standards of tax reform.

# Testimony

on behalf of the
Joint Commission on Federal Relations,
American Association of Community and Junior Colleges,
and the Association of Community College Trustees

by

Frank Mensel
Director of Federal Relations, ACCT;
Vice President for Federal Relations, AACJC and
national Cochair of the Coalition for Employee Educational Assistance

Mr. Chairman, on behalf of the Joint Commission on Federal Relations of the American Association of Community and Junior Colleges, and the Association of Community College Trustees, we are pleased to have this opportunity to submit testimony on the FY '88 Budget Reconciliation. These two associations represent more than 1,000 community, technical, and junior colleges across the nation, and their governing boards, comprising more than 5,000 trustees.

My name is Frank Mensel. I am Director of Federal Relations for ACCT and Vice President for Federal Relations of AACJC. I also cochair the national Coalition for Employee Educational Assistance, along with Piia Aarma of the National Association of Manufacturers and Greg Humphrey of the American Federation of Teachers. The following members of the Coalition have specifically asked to be associated with this testimony: the American Society for Training and Development, the National Association of Manufacturers, the American Council on Education, the National Association of State Universities and Land-Grant Colleges, the American Association of State Colleges and Universities, the American Assembly of Collegiate Schools of Business, and the Midwestern Universities Alliance.

As the largest branch of higher education, the nation's community colleges provide a variety of low cost, high-quality postsecondary education and training opportunities to more than 51 million Americans, in close proximity to their homes and their jobs. Community colleges also excel in partnershipping arrangements to deliver specialized training programs meeting specific employer needs.

Today, we urge your positive consideration of Senator Daniel P. Moynihan's bill, S. 39, which would make permanent the current law, Section 127, exclusion for employer-paid tuition assistance. Section 127 is due to expire on December 31, 1987, and we respectfully ask that you incorporate the language of S. 39 into the language of the reconciliation bill.

As you know, the employee educational assistance provisions of Section 127, have been a part of the Internal Revenue Code since 1978 (PL 95-600). Section 127 was enacted to eliminate the confusion created by a prior Treasury regulation (162-5) which required employees to demonstrate that the educational assistance provided to them by employers was strictly job-related. Otherwise it would be considered taxable income. This regulation, in effect, discriminated against lower-level employees, who had more narrowly defined job descriptions. Management personnel could justify almost any course content -- English, psychology, computers, etc., as related to their performance as managers. However, submanagerial employees, such as clerical workers and factory workers, were much more limited in the type of courses they could take, and still not have their tuition assistance taxed as income. The obvious irony was that the lower-level employees could less afford taxes on employer-paid tuition assistance than could management personnel!

Fortunately, Congress acted in 1978 to eliminate the inequities of Treasury regulation 162-5, by enacting Section 127. Over the past nine years, more than seven million workers have used employer-paid educational assistance to upgrade their skills to stay current with new competitive, technological and industrial developments. In addition, Section 127 has created incentives for upward mobility within the workforce.

Permanency for Section 127 is endorsed by a coalition (membership list attached) of more than 100 organizations including employers, employees, education institutions, unions, and business and trade associations, who recognize the value of Section 127 as a competitiveness policy that is already in place and working effectively to help reskill the nation's workforce. In preparation for Congressional testimony during the massive tax reform efforts of the 99th Congress, the chair of this coalition, the American Society for Training and Development, conducted a survey in 1985 on employee educational assistance programs--who pays for them, who benefits. The survey sample selected was 1,000 public and private employers with a range of 43 to more than 100,000 employees. From an approximate 30 percent response rate (319 responded), the survey revealed some very useful facts about Section 127 educational assistance programs:

**97% of all respondents have educational assistance plans

**91% of the respondents cited their local community college as a provider of educational assistance courses

**96% of respondents said educational assistance was used for improving skills and performance on-the-job

**54.8% of respondents said educational assistance helps employees learn basic skills like reading and writing

**72% of employees taking education and training courses earn less than $30,000 a year

Mr. Chairman, Section 127 is a small, but critical tax incentive that promotes training and retraining in the workplace. Much of this training could be lost if Section 127 is allowed to expire.

The expiration of Section 127 could also have a potentially devastating impact on graduate work and the nation's supply of scientists and engineers. Traditionally most colleges and universities have allowed graduate students to matriculate for classes at no cost to these students. The tuition reduction is, on the one hand, recognition for scholarly achievement, and on the other, compensation for time spent in teaching and research. Federal law until last year allowed graduate assistants to exclude the value of tuition reductions from their gross incomes. The Tax Reform Act of 1986, however, restricted the exclusion. The Act requires that graduate assistants pay tax on tuition reductions, granted as compensation for services. Scholarship payments in the amount of tuition and course-related materials are excludable, but reimbursements are not. Since the passage of the Tax Reform Act, many colleges and universities, those that pay graduate assistants wholly or in part with tuition reductions, have relied on Section 127 to make tuition reductions excludable. If Section 127 dies, graduate assistants will be required to pay tax on their tuition reductions, with the net effect that many very promising scholars would have to abandon their doctoral studies.

Graduate assistants are selected to teach and to conduct research because of their scholarly potential. Many in their number will be future college faculty members, and many will become leaders of science, business and government. Regrettably, without Section 127, the tax code would become a disincentive for graduate study.

Mr. Chairman, twice during its nine-year life, in 1983 and 1985, Section 127 has expired, causing confusion and concern among employers on their withholding and reporting liability for employees using their educational assistance programs. In both these instances, however, Congress acted retroactively (in 1984 and 1986) to extend Section 127 and to forgive employer withholding and reporting liability for the expired year. We are fast approaching another expiration date--December 31, 1987. By incorporating S. 39 in the FY '88 Reconciliation bill, confusion and concern among employers and employees over tax liability will be dispelled, and permanency can be accorded to this popular training incentive.

In conclusion, Mr. Chairman, we ask that the attached summary from the University of Alabama, illustrating its involvement in serving Section 127 workers, be included in the hearing record. Also attached is the current list of members of the Coalition for Employee Educational Assistance. Thank you again for this opportunity to share our views and concerns with members of the Finance Committee.

## EMPLOYEE EDUCATIONAL ASSISTANCE ACT

### (Section 127 of the Internal Revenue Code)

This provision of the Internal Revenue Code permits an employee to exclude educational assistance, such as tuition aid, provided by the employer from gross income.

This provision makes a significant contribution to improving U.S. productivity and competitiveness in the world marketplace by encouraging employees to acquire new knowledge and skills for coping with the changing workplace.

This provision is particularly important to employees in the 5th District of Alabama including those in the traditional manufacturing industries, the areospace complex and the computer-electronics industries.

The University of Alabama in Huntsville is particularly sensitive to the interests of working students. Many UAH students utilize EEA and some employers ask the University to report students' grades to them. While the University does not know the total number of students who utilize EEA nor all the companies, the University sent 2,044 reports during 1986-1987 fiscal year to 15 organizations including the following:

Alabama Department of Education
Huntsville Hospital
Marshall Space Flight Center
Saginaw
TRW
US Army Engineering Division
US Army Missile Command
USBI.

I estimate these UAH students would loose approximately $1 million per year in employee benefits.

C. David Billings, Dean
College of Administrative Science
University of Alabama Huntsville

ORGANIZATIONS SUPPORTING EMPLOYEE EDUCATION ASSISTANCE

AFL-CIO
American Assembly of Collegiate Schools of Business
American Association of Community and Junior Colleges
American Association of State Colleges and Universities
American Bankers Association
American Council on Education
American Electronics Association
American Federation of State, County and Municipal Employees
American Federation of Teachers
American Hospital Association
American Retail Federation
American Society for Personnel Administration
American Society for Training and Development
American Society of Association Executives
American Society of Engineering Educators
American Society of Mechanical Engineers
Ameritech
Association for Counseling and Development
Association of American Medical Colleges
Association of American Universities
Association of Catholic Colleges and Universities
Association of Community College Trustees
Association of Data Processing Service Organizations
Association of Jesuit Colleges and Universities
Association of Urban Universities
AT&T
Baltimore Gas and Electric
Bell Atlantic
Bell Communications Research, Inc.
Bell South
Brunswick Corporation
Communications Workers of America
Control Data Corporation
Council of Independent Colleges
Council of Graduate Schools in the United States
Data General
Deere & Company
Digital Equipment
Eaton Corporation
Edison Electric Company
Electronics Industries Association

FMS Corporation
Ford Motor Company
General Motors Corporation
General Telephone & Electronics Corporation
Hazeltine Corporation
Institute of Electrical Electronics Engineers
Intel Corporation
International Business Machines
International City Management Association

## ORGANIZATIONS SUPPORTING EMPLOYEE EDUCATION ASSISTANCE

AFL-CIO
American Assembly of Collegiate Schools of Business
American Association of Community and Junior Colleges
American Association of State Colleges and Universities
American Bankers Association
American Council on Education
American Electronics Association
American Federation of State, County and Municipal Employees
American Federation of Teachers
American Hospital Association
American Retail Federation
American Society for Personnel Administration
American Society for Training and Development
American Society of Association Executives
American Society of Engineering Educators
American Society of Mechanical Engineers
Ameritech
Association for Counseling and Development
Association of American Medical Colleges
Association of American Universities
Association of Catholic Colleges and Universities
Association of Community College Trustees
Association of Data Processing Service Organizations
Association of Jesuit Colleges and Universities
Association of Urban Universities
AT&T
Baltimore Gas and Electric
Bell Atlantic
Bell Communications Research, Inc.
Bell South
Brunswick Corporation
Communications Workers of America
Control Data Corporation
Council of Independent Colleges
Council of Graduate Schools in the United States
Data General
Deere & Company
Digital Equipment
Eaton Corporation
Edison Electric Company
Electronics Industries Association
FMS Corporation
Ford Motor Company
General Motors Corporation
General Telephone & Electronics Corporation
Hazeltine Corporation
Institute of Electrical Electronics Engineers
Intel Corporation
International Business Machines
International City Management Association

LARUS & BROTHER COMPANY, INC.

5721 SOUTH LABURNUM AVENUE, RICHMOND, VA 23231

TELEPHONE AREA CODE 804-222-3990

August 3, 1987

Senator Lloyd Bentsen
Senate Finance Committee
Suite 703, Hart Building
Washington, DC 20510

Dear Mr. Chairman:

Smoking Tobacco - In the past 10 years consumption of smoking tobacco has declined 56.9%. It has been off every year since 1984 by more than 10% per year and right now is running 20.4% behind last year's first quarter results. When the Federal excise tax on smoking tobacco was repealed in 1966, the tax was 10¢ a pound. If that tax rate were to be reinstated, the revenue derived would be $2 million dollars a year. Even at the extraordinary rate of 48¢ a pound, an option of the House Ways and Means Committee, the revenue would be less than $10 million.

In view of the fact that the aforementioned products do not raise significant revenues, I urge the committee not to consider excise taxes on these products in their effort to reduce the deficit.

Very truly yours,

W Brooks George

W. Brooks George
Chairman of the Board

# Testimony of Joseph Trevino
League of United Latin American Citizens
Submitted to the
Committee on Finance
U.S. Senate
July 15, 1987

My name is Joseph M. Trevino, and I am Executive Director of the League of United Latin American Citizens (LULAC). We are the nation's oldest and largest Hispanic organization, with over 110,000 members in 45 states.

I appreciate the opportunity to address the committee on a subject which has serious implications for Hispanics: proposed increases in federal excise taxes on everyday items such as gasoline, alcohol, tobacco and telephone service. These taxes have an adverse and disproportionate effect on Hispanics and other minorities.

Mr. Chairman, last year Congress took an important step toward tax equity when it passed the historic Tax Reform Act. That measure succeeded in linking tax responsibility more closely with ability to pay. Low-income citizens won fairer treatment under the new law, including a large proportion of Hispanics, blacks, women and blue-collar workers.

This year you are engaged in the unenviable task of taming the federal deficit. And in meeting that challenge, many of us are concerned that Congress will retreat from the progress made last year. Increases in excise taxes represent such a threat.

Excise taxes are regressive. They stand the concept of tax equity on its head, placing the greatest burden on those least able to pay. I've heard them called "reverse Robin Hoodism" -- taking from the poor to give to the rich.

Increases in these taxes would constitute a giant step backward for low- and middle-income people. I am sure you are aware of the recent report by the Citizens for Tax Justice which shows that, as a percentage of family income, the impact of excise taxes on low-income families is 27 times the impact on wealthy families. That report followed an earlier study confirming the regressivity of excise taxes, issued by your own Congressional Budget Office.

The CTJ report also found that raising the necessary new revenues through excise taxes would wipe out the tax benefits given to low- and middle-income citizens by last year's tax reform, while wealthy taxpayers would keep most of their 1986-enacted tax cuts. Similar conclusions were reached in a report issued by the Coalition Against Regressive Taxation.

**Unfortunately, Hispanics as a group are among those least able to bear this regressive tax burden.**

Hispanics have made, and continue to make, economic and political advances in this country. They have become integral contributors to our multiracial society. The percentage of Hispanic-Americans who have finished college has climbed over the last 12 years from 6 percent to nearly 11 percent, and this rise continues. The number and success of Hispanic-owned businesses is also increasing.

Hispanics are a fast-growing population. One out of every 14 people in America claims to be of Hispanic origin. The Hispanic population of the United States in 1985 reached 17 million, or 7.2 percent of all Americans, and is expected to surpass 25 million by the year 2000.

At the same time, however, Hispanics as a group continue to have among the highest levels of poverty and unemployment in the nation.

One in three Hispanics in the U.S. lives in poverty. Forty percent of Hispanic children -- 2.5 million in all -- live below the poverty line. The median Hispanic family income was $19,027 in 1985, a drop of 10 percent from 1973, and more than $10,000 less than the median for white families. The Census Bureau estimates that if current trends continue, Hispanics will surpass blacks in the next few years as the ethnic group with the highest poverty rate in the nation.

Let me add that the large number of these Hispanic families are working poor. For many of them, work is seasonal at best. And the income of a person working full time at minimum wage now falls about $2,100 below the federal poverty line.

**An excise tax increase may be an inconvenience to a family with a comfortable income -- but to families who have to watch every penny, it is more than an inconvenience, it is a tangible burden.**

It also is significant that several of the everyday goods subject to excise taxes are used by greater proportions of low-income Americans than by the higher-income population. And a taxable item like gasoline is a particularly important commodity to the large proportion of Hispanics, who are not concentrated in urban areas and do not have access to mass transit.

Excise taxes also unfairly affect Hispanic-owned businesses, most of which are small businesses. These establishments form the backbone of many Hispanic communities. They are much more vulnerable to price increases than are their larger competitors. When these businesses are forced to pass increased excise taxes along to consumers in the form of higher priced goods, the result can be lost business and lost jobs.

In closing let me reiterate that LULAC appreciates the difficult challenge facing Congress as it seeks to reduce the federal deficit. A healthy economy benefits all Americans.

But let us eliminate the deficit fairly and equitably, not by singling out one segment of society -- a segment which can least afford it -- to bear a heavier burden.

Thank you very much.

##

STATEMENT BY
WILLIAM F. GOROG, PRESIDENT
MAGAZINE PUBLISHERS ASSOCIATION
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 16, 1987

Mr. Chairman and members of the Committee. I am Bill Gorog, President of the Magazine Publishers Association, a national trade association made up of 200 publishing firms which publish about 800 magazines generally devoted to subjects of consumer interests. While we have not previously appeared before your Committee, I am sure that you and members of the Committee are familiar with many of our member publications -- both the national publications and the city and regional magazines which serve many of your districts.

We requested the opportunity to testify on an issue of tremendous importance to our members and to our industry -- the proposed limits on the deductibility of advertising costs which is included in the "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means."

As President of the Magazine Publishers Association, and as a former in the White House under President Gerald Ford, I believe I understand the difficulty of the task ahead of your Committee and the Congress. No one wants to raise taxes -- neither the Congress nor the taxpayers who have to pay them. Yet most Americans recognize the need to lower our budget deficits and applaud your efforts to address that goal. While I do not believe it is appropriate for me to suggest how someone else's tax burden should be increased in order to reduce the deficit, I believe I can add to what you already know about the function of advertising aand its importance to the magazine publishing business, as sell as why it should be a fully deductible cost of doing business.

Receipts from advertising represent approximately one-half of the total revenues of America's magazines. Because advertisers increasingly have more options available to them to send out their messages, the actual portion of magazine advertising revenues as a percentage of total revenues, has declined from 52 percent to 48 percent over the past eight years, and the percentage of advertising pages to total pages has dropped one percent. We are very concerned that any broad-based limit imposed on the deductibility of advertising expenses would accelerate this trend and further shrink a vital source of income on which magazines depend for their survival and their success. Advertisers could reasonably be expected to reduce total expenditures for advertising, including magazine advertising, if the same dollars no longer go as far after taxes, and they also are likely to seek out alternative, fully deductible promotional or sales expenditures.

Magazines are particularly vulnerable to shifts in advertising revenues. The ability of magazines to continue to provide valuable editorial material to their readers is directly related to continued support from advertisers. Magazines are businesses, and like other businesses, they try to produce a profit for their shareholders. Most magazines must operate in highly competitive markets. Entry into the magazine publishing business can be very difficult. For every 10 magazine startups, eight can be expected to fail, yet the startup of new magazines over the years has offered American readers a rich diversity of new information on subjects ranging from psychology to personal financial management to personal computing. These startups would not have been possible if early support had not come from advertisers willing to try to reach a new market. New magazines are bound to suffer disproportionately when the risk of reaching a new market is increased by the added cost of advertising attributed to its decreased deductibility.

I would hope that your Committee will be guided by the arguments prepared by your staff against limiting the deductibility of advertising because I believe they are far more persuasive than the arguments which may be made for such a limitation. I would like to review those arguments and to offer some additional observations about them.

1. Advertising costs represent the costs of selling a product in the current taxable year. They do not create a separate and distinct asset.

To treat advertising costs otherwise would be contrary to good financial and tax accounting. No element of advertising is viewed as a tax expenditure by any Treasury or Congressional staff report.

2. Even if some portion of advertising costs theoretically benefits future taxable years, it is only a de minimus amount.

Moreoften, it is the nature of the product being sold, rather than the advertisement, that gives rise to the theory that there is a lingering value beyond the appearance of an ad. For example, how long do you remember the price of brocolli advertised in a Giant or Safeway ad. But you may see an IBM or Apple computer in your office daily and observe a variety of automobile models every day which remind you of a particular product and may jog your memory about an advertisement.

3. The staff report wisely notes that it would begin to produce severe definitional and administrative problems to to distinguish between advertising or promotional expenses on the one hand and fully deductible selling expenses on the other. Your Committee would be presented with a wide range of appeals for exceptions attempting to draw the line in the law between advertising and selling expenses. For example, is the free copy of a magazine or newspaper an advertising or a production expense? Is the salary of a marketing director to be divided by some formula between advertising and non-advertising? In support of such a proposal, the staff report suggests that because benefits from the amounts paid for some advertising may extend beyond the year of the expenditure, deferral of the deduction for a portion of these costs would produce more proper matching of the costs with the income generated by them. But, no Treasury or congressional study makes this assertion, nor is there any empirical data which we have found which supports this thesis.

The staff concludes that advertising cost do not lead to increased competitiveness; they merely shift consumer buying priorities. Nothing in the Internal Revenue Code requires that an expenditure contribute to competitiveness before it may be currently deducted.

There is another feature to the staff proposals which I want to discuss separately because of its own particularly serious connotations. That is, the proposal to disallow altogether the deduction of advertising costs for alcohol and tobacco products. We believe this proposal raises serious public policy and constitutional questions.

I would imagine, however, that raising the caution flag of censorship in the area of tax policy may be met with some skepticism. After all, it was Mr. Justice Douglas, in the 1958 Case of Commissioner v. Sullivan, who said that "Deductions are a matter of grace and Congress can, of course, disallow them as it chooses." That opinion was handed down years before the Court had recognized that commercial speech also enjoys a measure of protection under the First Amendment.

In 1983, the Court in Regan v. Taxation with Representation (TWR) upheld the denial of tax-exempt charitable status to non-profit organizations that lobby, while allowing veterans organizations an exception to that rule. Some advocates of tobacco advertising restrictions argue that this case stands for the principle that Congress need not subsidize a First Amendment activity for it to be realized, and that statutory classifications are valid if they bear a rational relationship to a legitimate government purpose.

However, in a critical part of the majority opinion, the Court said, "The case would have been different if Congress were to discriminate invidiously in its subsidies in such a way as to "'aim at the suppression of dangerous ideas.'" Mr. Justice Blackmun reiterated this point in his concurring opinion stating that ". . . a statute designed to discourage the expression of particular views would present a very different question."

The key distinction between the cases in which the Supreme Court has upheld the denial of tax deductions potentially affecting the exercise of constitutional rights is over whether the speech that would be affected is viewpoint neutral or whether the legislation is aimed at the suppression of ideas. In the case of the proposed revenue options affecting alcohol and tobacco advertising it appears to be the latter.

Proponents of legislation to prohibit the deduction of tobacco advertising costs have described the purpose as requiring the Government to speak with one voice. They want the government to send its message by limiting the rights of others to present their message. I would like to include in the record a memorandum prepared for MPA concerning "The First Amendment and Alcohol and Tobacco Advertising Tax Deductions."

Surveys of the actual sale of tobacco products in other open market countries that have banned all tobacco product advertising indicate that sales remain constant or even increase. Thus, it would seem fair to assume that any reduction in advertising because of the limits on deductible costs could have little or no effect on consumption. Ironically, if it did, it could actually reduce federal tax revenues.

While we respect fully the goals of those who have introduced legislation designed to discourage consumption of alcohol and tobacco products, we believe that the Congress can achieve its goals by promoting more education for the American public without diminishing the principles of a free press and of free speech.

## Statement of Honorable James G. Martin
Governor
State of North Carolina
for the
Committee on Finance
United States Senate
July, 1987

The doubling of the cigarette excise tax in 1983 has had an adverse effect on the economy of North Carolina. Its effects have been well documented as to the loss in sales, jobs, and income of our historically number one commodity--tobacco. The proposed doubling, again, in 1987 of the excise tax from 16 cents to 32 cents would have a devastating economic effect. It is anticipated, based on previous experience, that North Carolina would lose 3,614 jobs and over $95.6 million in income and benefits in the tobacco industry. In addition, North Carolina would lose some $7.1 million in state and local tax revenues. North Carolina cannot afford to lose these jobs as the source of income during these days of severe economic stress in agriculture.

North Carolina last year produced over two-thirds of the flue-cured tobacco grown in the United States--over 430 million pounds. Thousands of North Carolinians depend on tobacco directly or indirectly for their livelihood.

The state grows flue-cured tobacco leaf in the Piedmont and coastal regions and also grows burley tobacco in the western mountain counties. The golden leaf is grown on approximately 21,000 farms in North Carolina and in 91 of North Carolina's 100 counties. Cash receipts from tobacco amounted to over $681 million in 1986. Slightly over twenty percent of cash receipts from all crops and all farm commodities came from tobacco.

At the other end of the spectrum, cigarette manufacturers in North Carolina produced over 18.872 billion packs of cigarettes in 1986. That's about 57.4 percent of all the cigarettes manufactured in the United States. North Carolina is the largest tobacco manufacturing state in the nation.

Other sectors of the North Carolina economy also benefit from the strength of the state's tobacco industry. There are tobacco auction markets in more than 30 counties in the state. Tobacco offers a variety of other support industries: The largest cigarette paper factory in the nation; chemical and plastic suppliers; packaging and container suppliers; cigarette filter producers; fertilizer and farm equipment suppliers; transportation industries; commercial printing; and advertising in the media.

All these industries produce important revenues for North Carolina and other states. Every business must earn a profit if it is to grow or even survive. If North Carolina's tobacco agriculture is successful, it not only benefits the farmer, but everyone. It carries its part of the tax load, it provides more and better jobs. If North Carolina's tobacco agriculture is unsuccessful, it provides fewer and fewer jobs and less opportunities for all.

The tobacco farmer has not shared in the economic recovery that most of the nation has experienced in the past few years. Not only has he faced increased foreign competition, but also a decline in domestic consumption due, in part, to the doubling of the excise tax in 1982. The entire tobacco program was in jeopardy of collapse prior to the approval, by Congress,of the Tobacco Reform Act of 1985. These changes, as explained to you by Mr. Fred Bond, managing director of the Flue-Cured Cooperative Stabilization Corporation earlier in the hearings, brought some degree of stability to the program and allowed many of our tobacco farmers to realize a profit for the first time in several years. Doubling the excise tax, with the resulting reduction in consumption, could very well cause many of our tobacco farmers to go our of business.

A staff working paper published by the Congressional Budget Office in January 1987, stated that "an increase in the excise tax on tobacco would be the most regressive of all the tax measures considered." As a percent of income, the tobacco excise tax is 27 times higher for lowest-income (under $10,000) families than for highest-income (over $200,000) families.

The tobacco grower would be unfairly disadvantaged by congressional action to raise the discriminatory tax on the product on which the grower depends for his livelihood.

In 1984, the Tobacco Institute reported that cigarette taxes collected at federal, state, and local levels of government amounted to $9.3 billion, while U.S. tobacco farmers who produced the domestic leaf for these cigarettes received only $1.45 billion. In other words, cigarette excise taxes are already more than six times the farm value of domestic tobacco used in cigarettes. This makes cigarettes the most heavily taxed consumer commodity in the United States today.

I hope that the tobacco grower will not be forgotten by my former colleagues when they deal with the future of the cigarette excise tax. To increase the cigarette excise tax above the current 16 cents per pack would be unfair, unreasonable, and unjustified.

# STATEMENT FOR THE RECORD
BY
PETER STRAUSS
PRESIDENT AND CEO
METROPOLITAN DISTRIBUTION SERVICES

Presented to The Senate Finance Committee
July 16, 1987

Mr. Chairman and members ot the committee, my name is Peter Strauss, President and CEO of Metropolitan Distribution Services, Inc., Flushing, New York. I am also a Vice President and Chairman of the Legislation and Tax Committee of the National Association of Tobacco Distributors.

Our Association represents over 570 corporate wholesaler-distributor members with over 740 distribution outlets in every state and represents 230 manufacturer and supplier associates. Their 12,000 salesmen together with our own canvass and supply almost 1.5 million retail outlets selling tobacco and candy products across the United States. It is estimated that our members market goods with an annual wholesale value of over $16.0 billion dollars.

NATD is also a member of CART, the Coalition Against Regressive Taxation.

Mr. Chairman, I appreciate the opportunity to present the views of the association with respect to increasing excise taxes. As a CEO of a corporation and as an individual taxpayer, I certainly applaud you and your colleagues for the enactment of last year's Tax Reform Act. The legislation brought a measure of fairness to the federal tax code by placing a greater share of the tax burden on those most able to pay and, in what I believe to be the most equitable part of the bill, reduced or eliminated the tax burden on those least able to pay.

The issue we would like to address today is fairness -- fairness to individual taxpayers and fairness to small business people. It is inconceivable that before the new elements of tax reform are even implemented, one of its cornerstones -- fairness -- threatens to be the first casualty in the budget process.

Let me state for the record that we are not opposed to measures intended to reduce the deficit; but we are adamently opposed to placing the burden on the very people last year's tax bill was intended to help.

In the past few months a number of studies, most notably by the Congressional Budget Office, the accounting firm of Peat Marwick Main and Company, and Citizens for Tax Justice, have been released. These studies analyzed the effect of additional excise taxes on different income categories and all confirmed the fact that excise taxes are clearly regressive. Indeed, the CBO study found cigarette taxes to be the most regressive of all excise taxes.

More importantly, these studies found that an increase in excise taxes of the magnitude currently being discussed would effectively eliminate the income tax reduction low and moderate income-tax payers expect to receive from the Tax Reform Act of 1986.

According to CBO, the average increase in taxes as a percentage of total income would be between two and three times as large for families with incomes between $10,000 and $20,000 as compared to families with incomes of $50,000 or more, depending upon the product being taxed. In the case of cigarettes it is a multiple of three.

Mr. Chairman, the issue of fairness is not new. I need not remind this body, on the 200th anniversary of our Constitution, of the part it played in our earliest origins as a Nation, and in the drafting of that document. However, it never hurts to repeat what Alexander Hamilton wrote in The Federalist Papers:

> "There is no part of the administration of government that requires extensive information and a thorough knowledge of the principles of political economy so much as the business of taxation. The man who understands those principles best will be least likely to resort to oppressive expedients, or to sacrifice any particular class of citizens to the procurement of revenue. It might be demonstrated that the most productive system of finance will always be the least burdensome."

Mr. Chairman, the studies I referred to earlier and the lessons of our history clearly illuminate the fact that raising excise taxes is not the least burdensome system.

It is often said that facts speak for themselves, but only if they are facts, and not myths such as those surrounding the tobacco industry in general and the wholesale distribution industry in particular.

**MYTH:** Cigarette excise taxes have not kept pace with inflation.

**FACT:** The increase in the CPI from 1951-1985 was 421%. The aggregate federal, state and local cigarette tax collections in the same period increased 601%

MYTH: Cigarette excise taxes have not been raised for over five years.

FACT: Excise taxes on cigarettes were "technically" raised last year. In 1982 the excise tax on cigarettes was doubled from 8 cents per pack to 16 cents per pack by the Tax Equity and Fiscal Responsibility Act (TEFRA) with the provision that the increase would "sunset" on October 1, 1986. The sunset date was postponed no less than five times by the Congress.

| | Original Date | New Date |
|---|---|---|
| P.L. 99-107 | Oct. 1, 1985 | Nov. 15, 1985 |
| P.L. 99-155 | Nov. 15, 1985 | Dec. 15, 1985 |
| P.L. 99-181 | Dec. 15, 1985 | Dec. 18, 1985 |
| P.L. 99-189 | Dec. 18, 1985 | Dec. 19, 1985 |
| P.L. 99-201 | Dec. 19, 1985 | Mar. 15, 1986 |

March 15, 1986 came and went without an extension of the "sunset" date. However, on March 20, 1986 the Congress abolished the "sunset" date making the 8 cent increase permanent retroactive to March 15, 1986.

Thus, although the rate of the federal cigarette excise tax remained the same, it was technically an increase over the amount it would have been if the "sunset" was allowed to take place as Congress intended it when it adopted TEFRA in 1982.

MYTH: The tobacco industry is "big business" and will not be adversely affected by an increase in excise taxes.

FACT: The average tobacco distributor is a small family owned and operated business with limited capital. A 16-cent increase on every pack of cigarettes will force most distributors to go to the commercial market to finance the additional cost of inventory.

MYTH: Wholesalers can simply pass any additional costs on to the retailer.

FACT: The wholesale distribution system is highly competitive. The wholesaler who passes on all costs, including the financing of loans to pay for inventory, would not remain competitive and is likely to lose customers.

Mr. Chairman, the overriding fact is that the cigarette industry already pays its fair share of taxes. Over $9.0 billion was paid in cigarette excise taxes last year to federal, state and local governments.

Finally, on the subject of the excise tax itself, it must be remembered that federal excise taxes impinge upon traditional sources of state and local revenue, such as sales taxes. Any actions to increase the federal excise tax on cigarettes will be magnified in their effects on the ultimate consumer by virtue of the increases automatically generated at the state and local levels -- thereby only multiplying the regressive factors inherent in this kind of taxation.

The specific industry I represent, the wholesale tobacco and candy distributors of this country, ask that you strike from your list a revenue options any consideration of increasing cigarette excise taxes.

However, since we recognize that among all the competing interests which you must consider some will lose the battle, we must also take this opportunity to be heard about the implementation of a cigarette excise tax increase should our basic plea go unheeded.

I again refer to the issue of fairness -- this time with respect to the imposition of a floor-stocks tax on wholesalers. To repeat the unjustice of 1983 would add insult to the injury of a tax itself.

You are aware that the federal excise tax on cigarettes is imposed at the manufacturing level. To impose a floor-stocks tax on the wholesalers -- the man in the middle -- and at the same time exempt the retailer as was done in 1983 cannot be justified on any grounds other than the most arbitrary -- particularly in light of the fact that the incremental, one-time gain in revenue, net of expenses, is minuscule. On the other hand, there is palpable and serious hardship imposed on the distributor by a floor-stocks tax. Indeed, the "options papers" prepared by the

Joint Committee staff state, "Floor stocks taxes impose administrative burdens on retail and wholesale dealers in taxable articles."

We have prepared a very thorough report on this issue which I am submitting to the Committee rather than taking your time now. However, I would like to conclude my testimony with a brief executive summary of the most important points made in that report:

- Direct-buying retailers, many of whom are larger than many wholesalers, have been exempt from floor-stocks tax, which puts the wholesaler at a severe competitive disadvantage.

- Penalizing the wholesaler by not allowing him the same inventory gain opportunities as the retailer is not fair, particularly in light of the distributor's extra costs associated with financing the higher inventory costs imposed by an increased excise tax.

- An excise tax increase will exacerbate the decline in cigarette consumption -- as it did after 1983 -- and in doing so will also exacerbate the deterioratory economic status of this country's wholesale tobacco and candy distributors. A floor-stocks tax adds insult to this injury.

We recognize that it is virtually impossible for a floor-stocks tax to be implemented at the retail level. Therefore it is our contention that in the interests of fairness, common sense, and the economic stability of the wholesale distribution industry, no floor-stocks tax should be imposed at wholesale in the event the excise tax on cigarettes is increased. By law the federal excise tax on cigarettes is a liability placed upon the manufacturers. The government should not use the event of an excise tax increase to penalize the thousands of small businesses that are represented by the wholesalers of this country.

Thank you very much for providing us the opportunity for presenting our views.

### Statement For the Record

By

Robert A. Hess

Chairman

National Association of Federal Credit Unions

The National Association of Federal Credit Unions (NAFCU) appreciates this opportunity to comment for the record as part of the Finance Committee hearings on Revenue Increase Options. My name is Robert A. Hess, I am the Chairman of the Board of Directors. NAFCU is the only national organization exclusively representing the interests of credit unions chartered by the federal government. There are approximately 9,600 federal credit unions nationwide with over 31 million members. The entire universe of credit unions, both state and federally chartered, is approximately 15,000, with 54 million members.

NAFCU is deeply concerned by the proposal to repeal the tax-exempt status of credit unions made in the Description of Possible Options To Increase Revenues Prepared For the Committee on Ways and Means issued by the staff of the Joint Committee on Taxation. This proposal was thoroughly considered and dismissed last Congress during the debate on the Tax Reform Act of 1986. The decision not to tax credit unions despite the fact that the President's tax reform proposal of 1985 had recommended a contrary course, was the product of a deliberate reflection on the part of Congress that as member-owned, volunteer-oriented, nonprofit cooperatives, the taxation of federal credit unions would inure to the detriment of the millions of hard-working men and women who comprise credit union membership. Contrary to the rationale given by the Treasury Department in 1985 supporting the elimination of the credit union tax exemption, Congress saw that federal credit union operations are so circumscribed by statutory restrictions that there was no credibility to the contention that credit unions compete with other financial institutions. The federal statute under which federal credit unions operate does not allow these cooperative institutions to serve the general public or to offer the extensive array of loan and investment opportunities available to commercial financial institutions, making competition with these institutions an impossibility. After carefully considering the issue, Congress recognized that financial institution competitiveness would not be enhanced through credit union taxation. This conclusion was urged by the Chairman and the ranking minority member of the Senate Banking Committee. Last August they wrote:

> As you know, credit unions are unique financial entities in that they are non-profit member-owned cooperatives. The credit union movement has always supported the American consumer. In particular, credit unions have acted with the special purpose of providing convenient and low-cost financial services to low and moderate income individuals. This special purpose would be substantially undermined if credit unions were taxed, even if the tax applied only to large credit unions, because of the fragmentation it would cause in the credit union community.

In the less than twelve months that have elapsed since Congress last considered the matter of repealing the tax exemption granted credit unions, nothing in the financial marketplace has changed to warrant a different outcome on this issue. For this reason, as the Finance Committee considers the list of revenue options for 1988 NAFCU urges you to reject the proposal to tax credit unions.

An examination of the rationale underlying the proposal to repeal the credit union tax exemption, as contained in the document prepared by the Joint Taxation Committee, reveals its specious nature. As an association which represents federal credit unions we make this analysis in the context of the authorities provided federal credit unions under the Federal Credit Union Act (12 U.S.C. (1751). Statutes governing the operations of credit unions chartered at the state level may offer some variation.

The option offered by the staff of the Joint Tax Committee is the same as that made as part of the President's tax reform proposal in 1985: a repeal of the tax exemption for credit unions with $5 million or more in assets. These credit unions would be taxed on retained earnings.

By taking a divide and conquer approach, proponents of this proposal seek to chip away at the tax exemption that has historically been provided to federal credit unions. Admittedly only a minority of credit unions would be affected by this proposal; yet 80 percent of all credit union retained earnings, including statutory reserves, would be subject to tax. The number of credit unions that would be affected is not the basis upon which we criticize this proposal. It is the implicit assumption that underlies the proposal that once a credit union grows beyond a certain asset size, it is no longer a "credit union" in the true sense of the word. Nothing could be further from the truth! .

Credit union asset size is in the vast majority of cases directly attributable to the number of members who belong to the credit union. By law, federal credit unions are only allowed to serve individuals who fall within a defined field of membership (12 U.S.C. §1759). While credit union members must share a common bond (based upon occupation, association or residence) credit unions which serve a field of membership encompassing a large group of people will naturally be larger in asset size than those which do not serve similarly large groups. For this reason, credit unions which serve the employees of large corporations or those enlisted in the military will frequently be larger in asset size than, for example, smaller church affiliated credit unions.

Size alone, however, is the only factor which distinguishes these credit unions from others. They continue to adhere to the philosophy of mutual self help and the non-profit ideals that have been the traditional lynchpin of the credit union community. As non-profit cooperatives, large credit unions as well as small extend credit to many individuals who are not able to qualify for loans from commercial institutions. They offer savings opportunities for small savers without the fees and minimum balance requirements that diminish the value of savings at some commercial institutions. Predicating a credit union tax on the basis of size fails to recognize the fundamental character of credit unions and effectively penalizes a credit union merely for serving a larger membership field than another institution. Frankly, the historical basis upon which credit unions have been exempt from tax is as valid today for credit unions with assets greater than $5 million as it is for all credit unions.

After proposing a tax on credit unions with assets of $5 million or more, the Joint Taxation Committee further suggests that the credit union tax be applied to retained earnings. Although the Joint Taxation Committee document indicates that a specified amount of credit union income could be exempt from tax, it offers no analysis of the ramifications of a tax on credit union retained earnings.

Under the Federal Credit Union Act (12 U.S.C. §1762) federal credit unions are required to retain a portion of their income in reserves. The statute specifies appropriate reserve levels according to the asset size of the credit union and the length of time it has been in operation. According to figures annually collected by the National Credit Union Administration, the regulatory agency with responsibility for regulating federal and federally insured credit unions, 56 percent of federal credit unions do not have reserves which meet the statutorily prescribed levels. By taxing retained earnings, Congress will further prolong the time before credit unions will attain their required reserve levels.

Reserves are the safety net which enable financial institutions to weather fluctuations in the financial marketplace. Appropriate reserves are not only critical to the safety and soundness of particular institutions, but they also provide an essential source of needed liquidity and ultimately protect the assets of the federal deposit insurance funds.

A tax on credit union retained earnings is inconsistent policy on two bases. First, such a tax is a deterrent to the establishment of sufficient reserves, the foundation of economic stability. Secondly, it seems blatantly inconsonant for one law (the Federal Credit Union Act) to require credit unions to retain earnings for the purposes of building reserves while another (the Internal Revenue Code) threatens to impose a tax on that very activity. Furthermore, given the vicissitudes of the financial marketplace and the record failures of banks and savings and loan associations over the past two years, it would seem particularly inappropriate for this Committee to consider an arguably capricious tax which would only weaken the healthy financial structure of our nation's credit unions.

In support of their proposal to tax credit unions, the Joint Committee on Taxation points to the similarity of credit union services to some of those offered by other financial institutions. We urge the Committee to reflect momentarily on this recommendation. The suggestion is that credit unions be taxed like banks because they offer certain similar services. While the Joint Committee accepts the similarity between credit union services and those of banks and savings and loan associations, it fails to take similar cognizance of the dissimilarities in the manner in which credit unions offer those services in relation to other providers.

The Committee should recall that the genesis of credit unions was the frustration of individuals who could not find credit opportunities and a favorable return on savings at commercial financial institutions. Typically, these individuals were farmers or factory workers, or small business people who were left with little alternative by the commercial financial institutions but to pool their resources to meet the borrowing and savings needs of their community. Today the minimal financial services necessary to exist in modern society are far more extensive than the basic loans and savings accounts that were once the staple of credit union members. Indeed, anyone who receives a regular check from the government is encouraged to receive that payment by direct deposit -- making transaction accounts a necessity for access to those funds. Credit cards are also fundamental vehicles for consumer transactions and money cards respond to the needs of those whose work schedules do not allow them to visit the credit union during business hours.

The increased level of services that credit unions have provided their members over the years reflects the increased needs of their membership in a growingly complex marketplace. The similarity of these services to those provided by banks and savings and loan associations is not a basis upon which the credit union tax exemption should be repealed. If you believe the rationale of the Joint Taxation Committee, credit unions should be taxed for being responsive to the needs of their members.

Another argument that the staff of the Joint Taxation Committee puts forward in favor of credit union taxation is that credit unions have an unfair competitive advantage over other financial institutions. Again, this rationale for taxing credit unions fails to accurately portray credit union services.

Credit unions do not "compete" with other financial institutions. As stated earlier, credit unions are nonprofit, volunteer-oriented, cooperative institutions which serve a limited field of membership. Federal credit unions are prevented from offering their services to the general public by the Federal Credit Union Act. Not being in the business to make a profit eliminates credit unions from competition. Credit unions do not seek to capture an increasingly large share of the market to satisfy an anonymous group of shareholders. Instead their activities are defined by the needs of their members who share an equal voice in determining the course their credit union will follow.

An assumption that underlies the Joint Taxation Committee's proposal is that credit unions are able to outprice other financial institutions because credit unions pay no taxes. This assumption fails to acknowledge however, how the pricing structure of other financial institutions would change if they were to operate on a non-profit basis. Additionally, 240,000 volunteers are the back bone of the credit union community. By statute, (12 U.S.C. {1761) only one credit union board member can be compensated for his or her services. Nationwide more than one-third of all credit union operations are entirely dependent upon volunteer support. The average bank director, on the other hand, receives a directors fee of approximately $13,000 annually. If credit unions enjoy a pricing advantage in terms of services, that advantage is the direct result of the strong volunteer support credit unions receive and their non-profit orientation. Credit union volunteers should not be rewarded for their dedicated service by repealing the tax exemption accorded credit unions.

As mentioned earlier, competitive parity will not come to the financial marketplace by taxing credit unions. Although some will mischaracterize the nature of credit unions, credit unions do not serve the general public or have the same lending and investment opportunities that other institutions can offer. Credit unions are limited to serving a well defined field of membership and only make loans that have an overriding consumer orientation. Since credit unions are prohibited from making a profit, from serving the general public and from making anything other than consumer-oriented loans, it is difficult to appreciate how some can contend that credit unions can effectively "compete" with banks. On the contrary, a tax on retained earnings would weaken the financial stability of credit unions and work to the detriment of credit union members.

The credit union presence in the financial marketplace is oriented to services in areas that have been neglected by commercial financial institutions. If credit unions were to be taxed, this Committee would be validating a gross distortion of the credit union role in the financial marketplace.

Although credit unions do not pay taxes, they do make a significant contribution to deficit reduction. In January, as a result of a provision included in the Deficit Reduction Act of 1984, all federally insured credit unions which experience a growth in shares will be required to make a deposit with the National Credit Union Share Insurance Fund (NCUSIF), the federally administered insurance fund that insures accounts at federal credit unions up to $100,000. Since the 1984 law, to maintain the capitalization of the NCUSIF all federally insured credit unions have been required to maintain a deposit equivalent to one percent of their insured shares with the NCUSIF. These funds are held in the Treasury and as a result have a beneficial impact on deficit reduction, according to the Office of Management and Budget. For 1988, the annual federally insured credit unions contribution is expected to be $250 million, effectuating a dollar for dollar reduction in the deficit. Interestingly, this is $50 million more than the Joint Taxation Committee estimates will be generated by taxing the earnings of all credit unions in 1988. Since 1985, federally insured credit unions have contributed in excess of $1.2 billion to deficit reduction.

NAFCU urges the Finance Committee to reject the proposal to repeal the credit union tax exemption. This proposal is no more valid today than it was last year when after due consideration, Congress summarily rejected the same proposal.

# STATEMENT OF

# THE NATIONAL ASSOCIATION OF HOMEBUILDERS

before the

COMMITTEE ON FINANCE

UNITED STATES SENATE

on

REVENUE INCREASE OPTIONS

AUGUST 17, 1987

The National Association of Home Builders (NAHB), a trade association representing more than 147,000 members, is pleased to have this opportunity to submit a statement for the hearing before the Senate Committee on Finance on revenue increase options.

The 99th Congress spent a substantial amount of time and effort in enacting a tax reform bill that many people did not want and that many more people do not understand. NAHB was vocal in its opposition to the tax reform effort, beginning with the release of the Treasury's first set of proposals in November of 1984, and continuing through October 22, 1986, the day President Reagan signed the bill. The housing and real estate industry has paid its dues both in budget cuts since 1980 and through tax reform. Revenue options should now be directed elsewhere.

NAHB continues to be concerned about certain aspects of the Tax Reform Act of 1986. The jury is still out on the Tax Reform Act of 1986. Certainly, there are some positive aspects in the 1986 Tax Act, such as substantial tax rate reduction for individuals and corporations and the removal of several million taxpayers from the tax rolls. However, we feel that the negative aspects may still outweigh the positive aspects. Many of the negative aspects of tax reform will not even be known to a substantial number of taxpayers until next year when they begin filing their 1987 tax returns.

Like many sectors of the economy, housing won some battles and lost some battles in the quest for tax reform. With regard to single-family housing, NAHB was pleased, of course, that the law retained deductions for mortgage interest on up to two residences of a taxpayer and deductions for real property taxes. We were encouraged by the retention of the mortgage revenue bond program, even though it was cut back significantly in terms of volume. However, NAHB was quite discouraged with the large number of adverse changes affecting multifamily housing. These changes included repeal of the long-term capital gains exclusion, substantial lengthening of real property depreciable lives, imposition of the passive activity loss limitation, and a significantly more inclusive minimum tax.

Current NAHB policy strongly endorses the use of tax incentives to promote home ownership and construction and rehabilitation of affordable rental housing. Because tax incentives for rental housing have been eliminated or sharply curtailed and tax-exempt financing for housing has been restricted under the new tax law, NAHB believes there will be higher rents and less low-and moderate-income housing available. We will monitor the impacts of tax reform on various segments of the housing market and, when necessary, suggest corrective legislation. While it is too early to know the full impact of tax reform on multifamily housing, it is already clear that multifamily housing has been affected adversely. Multifamily housing starts during April, 1987, fell to an annual rate of 449,000, down 14 percent from March. For the first four months of 1987, multifamily construction was off 28 percent from the building rate of a year ago. Multifamily starts in May increased by 10.8 percent, to an annual rate of 491,000 units. However, an ongoing decline in multifamily building permits, which dropped to a rate of 472,000 in May, suggests that multifamily housing starts will drop further this year as the result of high vacancy rates and the new tax law.

NAHB surveyed its members on the impact of tax reform at its 1987 Annual Convention and Exposition in January. 92 percent of our multifamily builders felt tax reform would be negative. Specifically, the effect of tax reform on multifamily for sale and multifamily for rent will be "very negative" to "somewhat negative" according to 40 percent and 52 percent of builders, respectively. In contrast, about 20 percent of builders felt that the effect of tax reform on single-family housing will be "somewhat negative" to "very negative."

In its testimony before the Finance Committee in 1985, NAHB stated that tax reform should facilitate tax compliance with an eye towards fairness and deficit reduction. Tax reform largely has failed on both grounds. There was no deficit reduction, because the increased revenues achieved from base broadening was used to reduce the tax rates rather than being applied to deficit reduction. Had some of the revenues generated from base broadening been applied to deficit reduction, our members might have understood the need for sacrifice. Having contributed substantially to the rate reductions in the 1986 Tax Act, we oppose efforts that would delay or postpone the implementation of these rate reductions. Tax reform also failed on the count of fairness because of the disproportionate burden that was borne by the real estate industry. One needs only to examine the passive activity loss rules and the way they deem rental real estate (and no other activity) to be a passive activity, without regard to material participation, to see how unfair the 1986 Tax Act is. The passive activity loss rules, alone, amount to a tax increase of $36 billion over the next five years, a large part of which will be borne by the real estate industry.

Because the housing sector of the economy bore such a large share of the base-broadening changes that funded last year's tax reduction, NAHB submits that it would be inequitable to again single out housing to bear the burden of deficit reduction. Housing also has paid a disproportionate share in budget cuts, where over 70 percent of budget cuts have been made in housing since 1980. NAHB believes that the deficit should be reduced through an appropriate mix of fiscal and monetary policies. If the tax system is going to be revised in order to reduce the deficit, the revision should be done in such a way to spread the pain among all individuals and businesses. Furthermore, the Committee should remain cognizant of the significant tax increases that were imposed upon the real estate industry both by the Tax Reform Act of 1986 and the Deficit Reduction Act of 1984.

The "Description of Possible Options to Increase Revenues" (JCS-17-87), prepared for the Committee on Ways and Means by the staff of the Joint Committee on Taxation with the staff of the Committee on Ways and Means, contains several revenue increase options that concern NAHB because of their potential adverse impacts upon home owners and the housing industry.

Among the options that would affect home owners are:

o Across-the-board reductions in the benefit of itemized deductions;

o Repealing, or otherwise restricting, interest deductions on home equity loans;

o Limiting the benefit of itemized deductions to the lowest tax rate bracket;

o Disallowance of deductions for nonbusiness personal property taxes;

o Imposition of a floor under aggregate itemized deductions of higher-income taxpayers; and

o Income taxation of net appreciation in property passing at death.

Among the options that would affect the housing industry are:

o Imposition of a value added tax or a business alternative minimum tax;

o Reduction in corporate tax preferences;

o Repeal of the completed contract method of accounting for large contractors;

o Limitations on deductibility of advertising costs;

o Repeal of the installment sales method for dealers and certain nondealers;

o Taxation of master limited partnerships as corporations;

o Several proposed changes regarding limited partnerships, including treatment of limited partnership income as portfolio (rather than passive) income under the passive activity loss rules;

o Repeal of like-kind exchange treatment for real estate;

o Increases in individual and corporate minimum tax rates; and

o Withholding on payments to independent contractors.

## Revenue Options Affecting Home Owners

The Internal Revenue Code historically has provided several tax incentives to encourage homeownership. The major tax incentive for homeownership is the mortgage interest deduction. Without the mortgage interest deduction, the cost of homeownership would be significantly higher.

For the first time in 40 years, the homeownership rate in the United States is declining. This trend, which started in 1980, is most pronounced among young Americans considering the purchase of their first home. The homeownership rate among all households peaked in 1980 at 65.6 percent. Since then, it has fallen to 63.8 percent. Among married couples in the 25 to 29 age group, homeownership fell from a rate of 59 percent in 1978 to 52 percent in the first quarter of 1987. For married couples in the 30 to 34 age group, the homeownership rate fell from 75 percent in 1978 to 70 percent in 1985. Given this downward trend in the homeownership rate, NAHB urges that the Tax Code not be tampered with in such a way to make homeownership less affordable. In fact, in a different budgetary climate, we would be urging new tax incentives designed to make homeownership more affordable, particularly for young American families. For example, for years, we have supported the concept of providing a housing savings account, similar to an individual retirement account, to assist first-time home buyers in accumulating a downpayment.

While the Tax Reform Act of 1986 largely preserved the tax deduction for mortgage interest, it did cut back on the mortgage interest deduction in two significant ways. First, the deduction for mortgage interest was limited to debt on no more than two personal residences of a taxpayer. Second, the amount of debt against which mortgage interest deductions may be taken generally was limited to the purchase price of the home plus the cost of improvements. However, an exception was provided for qualified educational loans and loans for medical expenses, to the extent that the debt is secured by a personal residence and does not exceed its fair market value.

On the one hand, we understand why Congress restricted the mortgage interest deduction in this manner. The concern was that homeowners could largely avoid the new limits on deductibility of interest on personal loans merely by using their homes as collateral for consumer debt. On the other hand, it should be noted that for many Americans their homes represent the bulk of their accumulated wealth. We do not believe that home owners should be forced to sell their homes in order to make use of that wealth. Thus, while there may have been some rationale to the restrictions imposed by the 1986 Tax Act, we urge that no further changes be made in this area.

We oppose other revenue options that would cut back on the benefits of the mortgage interest deduction. These include an across-the-board reduction of 10 percent for itemized deductions, the imposition of a floor under the aggregate itemized deductions of higher-income taxpayers, and limiting the benefit of itemized deductions to the lowest tax rate. Each of these proposals would diminish the tax incentives for homeownership and, thus, would make homeownership less affordable. Furthermore, each of the proposals would make an already complex tax system even more complicated, and, thus, could foster wide-spread disrespect for the tax system among middle-and higher-income taxpayers.

Finally, we oppose the income taxation of the net appreciation in property passing at death because of the increased record keeping burdens that would be imposed, the tax compliance problems that would be caused, and the increase in taxes on assets passing from one generation to another.

## Revenue Options Affecting the Housing Industry

There is no question that home builders were adversely affected by the Tax Reform Act of 1986. Single-family home builders were hurt by the taxation of contributions in aid of construction (which has added significantly to the cost of construction), the proportionate disallowance rule applicable to installment sales, and the new volume limitation on mortgage revenue bonds. The taxation of contributions in aid of construction, which many Members of Congress understood merely to be a tax increase for utility companies, has been a tremendous burden for many single-family home builders. This is because the utility companies basically have been "grossing-up" the tax cost to builders. Assuming a 40-percent Federal corporate tax rate, this gross-up to the builder amounts to a 67 percent increase in the cost of utility infrastructure.

Multifamily home builders were adversely affected by, among other provisions, the repeal of the capital gains exclusion, the substantial lengthening of depreciation lives, the passive activity loss restrictions, the volume limits on multifamily industrial development bonds, and the broader minimum tax. Since home builders, in effect, paid for a large part of last year's tax rate reductions, NAHB does not think that it would be equitable to now ask that home builders bear the burden of deficit reduction.

The benefit of the installment sales method of accounting was reduced significantly both for dealers and nondealers by the imposition of the incredibly complex proportionate disallowance rule. Furthermore, for home builders who are subject to the minimum tax, the installment sale method was repealed. NAHB supports S.719, which would restore prior law for non-dealer installment sales. With regard to dealer installment sales, rather than repealing the installment sale method entirely, NAHB would urge you to look at a simpler alternative to the proportionate disallowance rule. One possibility might be to impose a flat-percentage disallowance on deferral of profits from dealer installment sales. For example, one-third of the profit could be included in income in the year of sale, thereby allowing deferral of only two-thirds of profit. This would be far simpler than the proportionate disallowance rule of present law, and would be much more fair than repeal of the installment method because it would recognize the liquidity problem inherent in installment sales.

Another accounting proposal that concerns NAHB is the proposed repeal of the completed contract method of accounting. Under the percentage of completion-capitalized cost method that was implemented by the 1986 Tax Act, large contractors must take into account 40 percent of the items with respect to a contract under the percentage of completion method. The remaining 60 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting (for example, the completed contract method). NAHB opposes implementation of the percentage of completion method for long-term contracts because builders who engage in the performance of long-term contracts are not certain of the amount, if any, of the profit they will realize on the contract; builders earn profits on long-term contracts only at the time they are completed (rather than on a proportionate basis over the term of the contract); and, in the absence of substantial progress payments in excess of out-of-pocket expenses, builders may not have sufficient funds to pay tax prior to the completion of the contract.

NAHB opposes repeal of like-kind exchange treatment for real estate because like-kind exchanges merely involve a change in the form of investment and, thus, should not immediately give rise to tax liability. Furthermore, the present law provision which allows nonrecognition of gain on like-kind exchanges of real estate facilitates the mobility of capital. Limiting like-kind exchange treatment to simultaneous transfers of real estate would impose serious hardships on transferors who cannot immediately locate suitable replacement property. Moreover, it should be noted that the Deficit Reduction Act of 1984 already has limited the flexibility of like-kind exchange treatment generally by providing that transactions can qualify for nonrecognition treatment only if replacement property is identified within 45 days and transferred within 180 days of the original transfer.

Several of the revenue increase options presented for the Committee's consideration deal with limited partnerships, including master limited partnerships. Notwithstanding the adverse tax changes contained in the Tax Reform Act of 1986, limited partnerships remain a popular investment tool because they allow individuals to invest in more and larger projects than they could individually. The average investor has neither the time nor expertise required to identify desirable projects; conduct feasibility studies; or arrange for acquisition, financing, construction, or rehabilitation or ultimate management of the project. With a limited partnership syndication, these tasks are entrusted to professionals.

Master limited partnerships (MLPs) are a comparatively new form of ownership for real estate, especially for existing properties. MLPs are limited partnerships in which the partnership interests are traded on a national stock exchange. Investor interest in MLPs is high because, in contrast to most limited partnerships and other real estate investments, the ownership shares are liquid, thus allowing investors who need cash to easily sell their shares. Despite this liquidity, investors are able to avoid the double taxation inherent to corporations.

Limited partnerships are a valuable financing tool for raising the capital needed to construct new housing. Because the 1986 Tax Act severely limited the tax advantages from limited partnership investments in real estate, investors are now forced to consider the economics of an investment, largely without regard to any tax benefits. Due to this fact, we urge you not to adopt further changes that would have an adverse effect on limited partnerships, and, thus impede the flow of money needed for new construction.

We are particularly concerned with the proposals that would tax MLPs as corporations and treat net income of a limited partnership as portfolio (rather than passive) income. With regard to MLPs, there is little evidence that real estate MLPs are causing an erosion of the corporate income tax base. For example, limited partnerships have been traditionally used for holding real property. Using the MLP format to improve liquidity is a valuable tool for attracting investment capital.

To arbitrarily deem net limited partnership income to be portfolio income, while net limited partnership losses are treated as passive losses, would basically negate the viability of the limited partnership form as a tool for real estate investment. It would mean that losses could not be deducted against income generated from another partnership. This would be almost tantamount to disallowing limited partnerships as a tool for real estate investment. To further restrict the viability of limited partnerships, before the ink has even dried on the Tax Reform Act of 1986, would be patently unfair.

Several other proposed revenue increase options concern NAHB because they would mean increased taxes for home builders, which, ultimately, would mean increased prices for new homes. These options include limitation on the deductibility of advertising costs, increases in corporate and minimum tax rates, and withholding on payments to independent contractors.

Taxes for many builders will increase substantially this year due to last year's tax reform. NAHB feels it would be unfair to again raise the taxes of these builders before the full impacts of the 1986 Tax Act are even fully felt. Furthermore, we question the utility of requiring withholding on payments to independent contractors when those payments are already required to be reported to the Internal Revenue Service. Rather than increasing tax compliance, requiring withholding on payments to independent contractors would only add complexity and additional administrative costs and burdens for builders who use independent contractors in their construction business.

One bright point in the revenue options deals with the reinstitution of a capital gains tax differential. NAHB, of course, would support favorable tax treatment for capital gains, but not at the expense of other options that would increase taxes for home owners and home builders. A reduced capital gains tax rate would likely increase Federal tax revenues because it would promote economic growth.

Finally, we would like to note the discussion of a value added tax (VAT) and a business alternative minimum tax (BAMT). These are ideas that merit serious attention in the context of deficit reduction, however, if they are going to be given serious attention, they deserve at least as much time as was devoted to consideration of the Tax Reform Act of 1986. Any consideration of a VAT should, of course, be done in such a way as to minimize any increases in housing costs. A BAMT, that affects all businesses in an equal way, might not be objectionable to NAHB if it returns some revenue to tax incentives such as capital gains and shorter depreciation lives for real property.

# STATEMENT

# BY

# THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Submitted by: Danea Kehoe Martin
Counsel, Government Affairs
National Association of Life Underwriters

The National Association of Life Underwriters (NALU) thanks the Committee for the opportunity to comment on the revenue increase options presented by the staffs of the Joint Committee on Taxation and the Committee on Ways and Means. NALU is a federation of state and local life underwriter associations representing almost 135,000 professional insurance agents who sell and service life and health insurance and employee benefit plans in virtually every community in the United States.

These hearings represent the first step in the process of raising $19.3 billion in new federal revenue in FY 1988, $22 billion in FY 1989, and $23 billion in 1990, as mandated by the 1988 Budget Resolution. A number of the some 200 committee staff pamphlet (JCS-17-87) options that are the focus of these hearings raise deep-seated concerns among life underwriters. These concerns are expressed on behalf of the 70% of American adults who own life insurance as well as those who sell it.

## LIFE INSURANCE TAX LAW JUST CHANGED; SHOULD NOT BE ALTERED NOW

The 12 proposals and subproposals that would change life insurance product and company tax law should all be rejected because they were debated during enactment of both the 1984 Deficit Reduction Act, (Title II, the "Stark/Moore Life Insurance Tax Law") which completely revised life insurance taxation and/or last year's tax reform legislation. Both debates focused not only on the policy underlying the various tax law provisions, but also on the appropriate level of revenue to be generated from life insurance products and companies. Further, the revenue questions were settled in the context of actual and projected Federal deficits even larger than those we currently face. The provisions are designed to produce triple the level of tax paid by the industry prior to 1984, and as yet there is no evidence to suggest a significant shortfall. The various provisions of the "Stark/Moore" life insurance tax law are scheduled for review by 1989. Preliminary studies, by the Treasury Department and the General Accounting Office, are expected this fall. As with Tax Reform itself, it is too soon to tinker with a radically new tax system because there simply has not been enough time to gather the data that will prove whether the new system is working as intended or needs adjustment. Thus, changes to life insurance tax law--if appropriate at all--are certainly unwarranted until the studies indicating how the law is working are complete. The soonest such changes should be contemplated is after Congress and the industry receive and have the opportunity to evaluate the preliminary data promised by the Treasury Department and GAO this fall.

## LIFE INSURANCE OWNERSHIP TOO WIDESPREAD TO BE TERMED "LOOPHOLE" OR "SPECIAL INTEREST"

The premise that revenue should be raised via closing "loopholes" enjoyed by "special interests" should not be applied to life insurance products. Some 70% of all adults in the U.S. own an average of $63,400 of coverage per family. It is hard to characterize tax provisions affecting such a large group as serving only a "special interest." A benefit this broad-based--not to mention as justified by both tax principles and social policy--cannot seriously be termed a "loophole." Rather, any set of tax rules that affects such a huge segment of the American public would be more properly classified in the same category as "the public interest," such as the tax rates themselves, the personal exemptions and exclusions, etc. "Loophole" and "special interest" are terms that suggest that a few taxpayers, taking advantage of specialized and specific transactions, benefit at the expense of the majority. This is simply not the case with respect to life insurance products.

NALU wishes to comment specifically on proposals that can be divided into three general areas: life insurance products, employee benefits and estate tax issues.

## LIFE INSURANCE PRODUCTS

There are eight proposals in the life insurance product area about which we are concerned.

### LIFE INSURANCE CASH VALUES SHOULD ACCUMULATE INCOME-TAX FREE, AS UNDER CURRENT LAW

Among the revenue proposals are two suggestions to make life insurance policy cash values (the "inside buildup") subject to tax on a current basis. The first proposal suggests current tax liability for annual increases in cash values for all newly-issued life insurance policies. The second would limit the proposal to life insurance policies owned by corporations or trusts. Both would be bad tax policy, bad social policy, and ineffective as revenue-raisers.

Life insurance cash values are not "income" actually or constructively received. Rather, they are a function of the level payment method of funding the death benefit. Policyholders pay a higher premium in the early years of the policy's life, to make up for premiums that are less than necessary to fund the death benefit during the policy's later years. If death occurs prior to the policy's maturity, the cash values become part of the death benefit. If the policy is surrendered or annuitizes or if its cash values are withdrawn prior to death, the cash values are taxable to the extent they exceed basis. Thus, under current law, cash values are taxable at the time they are actually or constructively received. The only exception to this rule is the situation involving the transmutation of cash value into death benefit.

Further, the rule that allows cash values to accumulate tax-free until death or distribution is wise social policy. Life insurance is an excellent source of capital formation. It is an important foundation of millions of retirement income plans. Cash value life insurance allows its owners to guarantee that their beneficiaries will receive the death benefit even if death occurs "later"--when term insurance premiums become prohibitively expensive--rather than comparatively early in life. Finally, estimates that a current tax on accumulating cash values would raise $700 million in new federal revenue over the next three years are highly suspect. NALU believes few if any people would buy permanent insurance if they faced tax liability on its cash values--and no "real" money with which to pay that liability--in ever-increasing amounts as the policy, and policyholder, ages. Thus, the $700 million revenue projection is largely illusory.

Confining the proposal to tax currently the life insurance cash values in corporate-owned policies does not remedy the basic defects of the proposal. The same basic tax principle, i.e., that "income" is taxable when received, is violated. The same mischief with respect to capital formation occurs. To tax currently corporate-owned life insurance cash values runs the risk of similar social harm. Rather than inadequately-protected spouses and children, the result would be inadequately-protected businesses and employees. In some ways, this is even worse in that a business without sufficient capital (provided by death benefits) after the death(s) of its owner(s) and/or key employees can devastate the livelihoods of all those employed by the business. Life insurance protection for businesses, especially small businesses, is a key part of the financial security not only of the business itself, but of the people it employs. Many thousands of small businesses have remained productive enterprises after the deaths of their founders because of the financial cushion for the transition period provided by life insurance death benefits. As with individually-owned permanent life insurance, current tax on policy cash values acts as a powerful disincentive to acquire adequate amounts of death protection, creating the same illusory, but near-certain false, estimates of additional Federal revenue.

For all the reasons cited above, life insurance cash values should not become a preference item for purposes of the alternative minimum tax. Because cash values are not properly characterized as income received, they should not be taxed (until and unless they are received) under tax policy measurement-of income-principles. Further, the social good provided by life insurance warrants its current law tax treatment, just as the potential drain on government welfare programs that would result from the inadequate protection level that would likely occur should cash values become subject to current taxation justifies a continuation of current law tax treatment of permanent life insurance.

## LOANS AND DISTRIBUTIONS PRIOR TO DEATH SHOULD BE TAXED AS UNDER CURRENT LAW

The options list includes three suggestions that would result in accelerleated or new tax liability as a result of policy loans or withdrawals. Two of these suggestions propose taxing life insurance as annuities are taxed; one would apply lower or no interest loan rules to life insurance loans. All three are misguided, both in terms of policy and in terms of the revenue they are estimated to raise.

A life insurance loan operates in all respects in the same way any loan operates. Market conditions dictate the interest charged on the loan, and the terms of repayment. (Since "collateral" for the loan is the death benefit or surrender value--both of which always exceed the loan value--and since both are payable in cash, a company has no need to force repayment within a specified time period. Death benefits or surrender value are sufficient guarantee of repayment.) All assets can be collateralized for their market value, rather than for their cost basis. No other loan (except annuity loans) triggers taxable gain when its proceeds exceed the asset's acquisition cost. Further, a fundamental principle of income tax law requires that a taxpayer receive his or her investment back prior to taxation of any gain upon liquidation of an asset. Thus, it is annuity law (at least with respect to the tax consequences of borrowing or taking an "early" withdrawal) that is the departure from the norm. It is bad enough that annuities are taxed on an unfair-in-principle basis. To extend that unfairness to life insurance would only exacerbate an unfortunate anomaly in the tax code.

Beyond the basic questions of fairness and soundness of the tax principles underlying life insurance product tax law there is the question of the harm to the financial security afforded to society by life insurance. Permanent life insurance is a long-term commitment that is made possible, in most cases, by the peace of mind that comes with knowing that loans or withdrawals, should they become necessary due to unforeseen or extraordinary financial events, are available on a tax basis that compares with the tax consequences of any other situation. Most frequently, the loans and/or withdrawals are either not taken or they are repaid, but their availability is a critical element in the decision to acquire a sufficient amount of life insurance protection in the first instance. Where loans or withdrawals are taken and not repaid, most often it is to keep the insurance in force. Loan and withdrawal values typically represent only a small fraction of the typical policy's death benefit.

Not only would adverse, unfair tax consequences imposed on policy loans and withdrawals depress the level of life insurance in force to potentially harmful levels (the decrease in capital formation and the increase in government subsidies to inadequately protected beneficiaries would both have long-term negative effects on our overall economy), but such a move would almost certainly fail utterly at raising the revenue the proposals estimate. It is unlikely that borrowing and withdrawing would continue at present-day levels, just as it is unlikely that the same level of life insurance (and thus borrowable and withdrawable cash values) would continue at current levels. In fact, it would not be unreasonable to anticipate a revenue loss due to the lowered tax liability of the people whose livelihoods would be diminshed as a result of any such changes, and to the increase in Federal expenditures necessitated by an increase in inadequately protected survivors, small businesses and retirees.

## INVESTMENT-ORIENTED (SINGLE PREMIUM) POLICIES NEED FURTHER STUDY

The options list proposes redefining life insurance to exclude "significantly investment-oriented life insurance policies such as single premium life insurance policies." The proposal's authors generally define a "significantly investment-oriented policy" as one whose premiums are substantially in excess of the amount needed for level premium funding of the death benefit, or one whose investment income is derived from high-risk or high-return investments. NALU opposes this proposal as one that is dangerously overbroad, badly-defined and ill-conceived. NALU concedes that there may be some single premium contracts--in a class which does not include all single premium contracts--that are marketed as tax-sheltered investments. NALU is willing to work with the Ways and Means Committee to define properly the scope of any problems these policies may create, and to devise an appropriate response. However, the proposal described above is both too vague and too broad to respond to with anything but stiff opposition. It has been less than three years since Congress, after thorough study and intense debate, determined that for tax purposes life insurance should be allowed to be funded with a single payment. It is not the single payment which created the tax-sheltered investment to which some Congressional members now object. Nor is it appropriate to define life insurance by examining the investments into which a life insurance company puts its premiums dollars. In addition, such terms as "high-risk" or "high-return" investments are imprecise at best, subject to revision based on cyclical changes in the marketplace. For example, a 12% return would be considered quite high today, but 3 years ago investments yielding 12% or more were common. So, too, is the term "level funding of the death benefit" imprecise. What is "level funding?" Yearly premiums until the policy's maturity date? Yearly premiums for at least 5, 10, 15, 20 or 25 years? Yearly premiums until a certain age? Or something entirely different?

Aside from the issues presented by an overly vague proposal, the concept of redefining life insurance to exclude the single premium product would eliminate the historical, eminently justifiable use of the contract as an estate creation device. Single premium products are especially suitable to fund the cost of future education for a young child being protected by an older parent or grandparent. Thus while further study of the product as it is currently constructed, marketed and taxed is appropriate, a sweeping, destructive change of the nature proposed in the options list must be opposed. The General Accounting Office is currently conducting a study of the single premium policy, with results anticipated this fall. Also in the fall, GAO and the Treasury Department are scheduled to present to Congress preliminary data on the working of the "Stark/Moore" life insurance tax law. That is the appropriate time and context for a review of "significantly investment-oriented" policies. NALU has been working with GAO and the Ways and Means Committee on this problem, and will continue to do so. In the interim, we must oppose the proposal presented in the options list.

## ANNUITIES SHOULD NOT BE TAXED MORE HARSHLY THAN AT PRESENT

As noted above, annuities are currently taxed in the harshest of ways. After-tax investment dollars must accumulate until retirement age, on pain of taxation of the investment yields before return of investment--a reversal of the usual rule--and a penalty tax. Still, annuities remain an important tool of retirement income planning. The options list suggests either making all annuity investment yields subject to tax in the year they are earned, or limiting tax-deferred accumulation of investment yields to amounts earned on investments of $50,000 or less.

This is yet another unfortunate idea. Demographic data indicate that Americans are living longer, and the fastest-growing segment of our population is the post-retirement group. This trend will increase as the "Baby Boom" generation ages into retirement. With such a trend clearly forecast, how can the government afford to undercut incentives to put away money to provide retirement income? Rather, we should be investigating additional incentives. Not only do retirement savings pump much-needed capital into the economy, they cushion the need for public support of older people after they complete their working years.

There is little or no room left for "abuse" of the annuity product. Only annuities owned by natural persons (actually or beneficially) enjoy the tax-deferred accumulation of investment earnings. Pay-out cannot be delayed beyond age 70½; pay-outs are fully taxable on a "blended" basis whereby only a portion (directly related to the ratio between investment and investment earnings) of the after-tax investment is returned prior to taxable investment income. Pre-retirement loans and withdrawals are taxed, on an investment interest first basis, and subject to a penalty tax. There is simply no justification for imposing even more restrictions on this retirement income vehicle, just as there is no wisdom in eliminating the annuity as a retirement planning tool. And again, estimates of increased revenue as a result of these proposals are largely illusory. There would be little or no market for a currently-taxable annuity, thus eliminating the possibility of generating tax dollars from its investment income. And even the revenue estimators concede only a tiny amount of revenue to be gained from limiting the size of a tax-deferred annuity to $50,000.

## COMPANY RESERVE DEDUCTION IS APPROPRIATE

NALU is admittedly no source of expertise on the appropriateness of the companies' reserve deductions. However, those deductions are directly related to the value of the products themselves. In the best interest of the policyholders represented by NALU, we support the companies' opposition to any change in the current law method by which the reserve deduction is calculated.

## EMPLOYEE BENEFITS

### EMPLOYER-PAID LIFE AND HEALTH INSURANCE SHOULD BE EXCLUDED FROM INCOME

Enormous amounts of revenue--anywhere from $3 to $40 billion (over three years)--are contemplated from a range of proposals that would impose tax liability on employer-paid life and health insurance. The very size of the revenue estimates suggests an integral contradiction in terming tax-free employee benefits a "loophole." The great majority of working Americans (and thus an even greater majority of taxpayers!) benefit from the tax code provisions that allow them to receive life and health insurance tax-free from their employers. Elimination or restriction of this benefit is tantamount to an increase in tax rates. At a minimum such a change would kill any tax cut the average taxpayer might have gotten as a result of tax reform, and perhaps transform it into a tax increase. But beyond that, taxable insurance benefits could lead to pernicious results that would put the Federal government in the position of having to provide the protection that used to be provided by insurance. This is because employees, faced with having to pay income tax on the value of life and health insurance, would likely pressure their employers into letting them decline those benefits. Of course, the younger and healthier employees--and the lowest paid--would be most likely to reject them. Not only does this leave the government at risk for death protection in the case of life insurance and health care costs in the case of health insurance for these employees (some, albeit only a relative few, of whom will die or become expensively ill or injured), but it will also drive up the cost of insurance for those who continue to accept the coverage. This is because those remaining in the insurance pool will be the (relatively) sicker and/or older employees. As their claims continue to drive up the cost of insurance, more relatively young and healthy employees will opt out, spiking another round of adverse selection.

Further, there is basic unfairness in trying to tax these benefits. The unfairness comes from valuation problems (for example, how do you calculate the "income" attributable to a beneficiary of a self-insured plan?); from wildly varying regional costs of health care and therefore of health insurance; from differences in rates attributable to the nature of the insured group (small vs. large, high-risk vs. low-risk occupations, etc.); and from the fact that many employees would be paying tax on duplicative coverage because both spouses must accept employer-provided health insurance.

A "cap" approach discourages cost-effective preventive care protection; a "floor" approach is regressive and hits lower-paid employees the hardest. Inclusion of these benefits in the Social Security wage basis is also regressive and discriminatory against those earning less than the wage base. The proposal to tax only those who earn $50,000-60,000 or more is just plain unfair and is especially hard on the two-income couple with duplicative coverage.

The proposals to limit cafeteria plan tax-free benefits, either by amount ($500) or by forcing benefits provided under a cafeteria plan into the Social Security wage base are more limited in their potential for damage, but for cafeteria plan beneficiaries the damage is just as real. And it is unfair to single out one form for providing employee benefits as a candidate for adverse tax treatment.

## PENSION LOANS SHOULD NOT BE FURTHER RESTRICTED

NALU joins in the comments submitted by our conference, the Association for Advanced Life Underwriting (AALU) with respect to the range of proposed pension changes, including the proposal to disallow (without tax penalty) any loans from a pension plan. Here, suffice it to say that we oppose these changes on the ground that it is becoming increasingly important to encourage adequate retirement planning, and these changes would discourage such planning. Further, pension law has been changed so repeatedly over the last decade that many employers are terminating or considering terminating their plans because of the expense of amending, administering and keeping up with continual changes.

## TAXATION OF LIFE INSURANCE UNDER THE ESTATE TAX

Under a proposed revenue option, the proceeds of an individual's life insurance policy would be included in his estate if they are payable to a relative (directly or indirectly) regardless of whether he owned the policy at the time of death. Under present law, life insurance is treated like all other assets for estate tax purposes and the proceeds are included in the individual's estate only if he owned the policy at the time of his death or within the prior three years. NALU opposes this revenue option for the following reasons:

## THE REVENUE OPTION FORCES BREAK-UP OF SMALL TO MID-SIZE BUSINESSES AND FAMILY FARMS

- For an owner of a small to mid-size business or farm, the business often constitutes most, if not all, of his estate. When the owner dies, an estate tax may be due, and, unless cash funds are available, the only alternative will be for the estate to sell the business to raise the funds to pay the tax.

- To avoid the need to sell the business, life insurance is commonly purchased to provide the cash to pay the estate tax. Because of its guaranteed death benefit, life insurance is the only vehicle which can insure that adequate funds will be on hand at the time of death.

- The proposed revenue option would impose an estate tax on these life insurance proceeds, even though the insurance does not increase the size of the estate. The new tax would make the cost of raising liquid funds virtually prohibitive and force many estates to sell the family business.

- The revenue option would also severely impact common buy-sell arrangements where life insurance is purchased to provide funds to surviving owners with which to buy the interest of the deceased owner.

- This revenue option is a direct attack on arrangements which are uniquely designed to keep small businesses and farms intact on the death of the owner. It should be rejected.

## THE REVENUE OPTION IS INCONSISTENT WITH THE CONCEPT OF ESTATE TAX

The estate tax is imposed on the "transfer of the [property of the] taxable estate of every decedent." The revenue option would impose the tax on property which the decedent does not own, and may never have owned, and thus cannot be considered to have transferred at his death. The ownership rights in a life insurance policy are well established and should control for estate tax purposes. The suggestion that an estate could be liable for a tax on assets never owned by the decedent raises serious constitutional issues.

## THE REVENUE OPTION DISCRIMINATES AGAINST LIFE INSURANCE

- Under this revenue option, life insurance would be the only type of property on which an estate tax would be imposed, even though the decedent transferred to another person more than three years before his death.

- Current law does not result in special estate tax benefits for transferred life insurance; it is treated exactly like other property interests. If the policy is transferred by gift, or the original owner continues to pay the premiums after the transfer, they will be subject to gift tax. There is no good reason for increasing the tax disparity for life insurance.

## SUMMARY

In summary, NALU opposes the life insurance, employee benefits and estate tax proposals described above. The extent to which changes in life insurance tax law may be appropriate, for policy or revenue reasons, cannot be determined rationally until the preliminary data on how the recently-revised life insurance tax law is working has been received and evaluated. This data is expected this fall. Life insurance and employee benefits are enjoyed by such a widespread cross-section of taxpayers that any change in the law governing them would be tantamount to a tax increase. Further, the economic foundation of literally millions of Americans could be seriously weakened were any of these proposals to become law. In addition, life insurance (and pensions) provide an important source of capital to the U.S. economy. To undercut either would risk harm to the economy itself. Finally, most of these proposals would operate on an uneven basis, resulting in discrimination against older, less healthy and lower-paid individuals.

NALU thanks the committee for this opportunity to express our concerns.

## Statement of the

## National Association of Photographic Manufacturers, Inc.

The National Association of Photographic Manufacturers, Inc. wishes to go on record in opposition to the proposal to place luxury excise taxes on photographic cameras, lenses, film, film projectors, video cameras and recording tape. The proposal was contained in the pamphlet entitled "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means," dated June 25, 1987 prepared by the staffs of the Joint Committee on Taxation and the Committee on Ways and Means.

NAPM is a voluntary trade association composed of companies which manufacture photographic and image technology equipment and supplies. On the equipment side they manufacture cameras, lenses and projectors; on the supply side they make photographic film, video and audio tape, photographic paper and photographic chemicals. Members include such companies as Agfa, Eastman Kodak, Du Pont, Fuji, Ilford, Konica, 3M, Peerless, Polaroid, Powers and others. Our members account for over 90 percent of the photographic products shipped to the United States market.

NAPM is opposed to the imposition of a luxury excise tax when the defined products include cameras, lenses, film, projectors, video cameras and recording tape. It appears from the pamphlet prepared by the staffs of the Joint Committee on Taxation and the Committee on Ways and Means that the above products were included as possible proposals for ad valorem excise taxes because such a tax had been imposed before. The Excise Tax Reduction Act of 1965 repealed these taxes.

NAPM was very active in working for that repeal. Our arguments then and our arguments now are the same. Photographic goods are not luxury items and should not be subjected to excise taxes. The definition of luxury includes the following: "An elegant appointment or material aid to the achievement of luxury; a nonessential item or service that contributes to luxurious living." We have some data on when United States households take photographs.[1] During the holiday season of Christmas and Chanukah, 88% of U. S. households take pictures to record the festivities. At birthdays approximately 79.2% of American homes take snapshots. We believe that picture taking at the above occasions in this day and age are not luxuries, but are necessaries to record the memories and enhance family life.

We also have demographic studies that indicate that people of very modest means purchase cameras and film.[1] The information indicates that the percentage of total U. S. households owning still cameras in the following income brackets are: annual income under $10,000 - 21%; $10,000-$19,999 - 24%; $20,000-$29,999 - 20%; $30,000 and up - 35%. The percentage of families owning any type of camera is 86.2%.

Photographic cameras, especially 35mm single lens reflex cameras commonly referred to as SLRs, are used not only by amateurs but by professional photographers, medical photographers, dentists, orthodontists, forensic and law enforcement experts, photojournalists, governmental photographers and in education and training situations. These cameras have traveled to the ocean's depths and to the far reaches of outer space with side trips to the moon.

Similarly, nonluxury uses for video cameras in many of the above situations and in production quality control and surveillance activities are common everyday occurrences. The film and tape used by the above equipment should also fall into a nonluxury category.

There also is a crossover in the use of film projectors by both professionals and consumers. In the field of education and training, for example, 16mm film projectors account for over 90 percent of sales made to industrial, educational and governmental agencies. In the photographic industry approximately one third of total sales are made to amateur consumers.

It is very difficult to distinguish at times whether an amateur or a professional user is buying the product. 35mm cameras, video cameras, tape, film and projectors can be used by both. Excise taxes, especially levied at the manufacturer's level, are hidden and discriminate against the users and producers of these products. They are inflationary and are basically unfair and a bad idea for raising revenue.

Excise taxes in the photographic industry may well reduce sales and therefore jobs in our industry. The Department of Commerce data in the 1987 Industrial Outlook indicate that the number of jobs in the photographic industry declined two percent in 1986 to 100,000.[2] The number of production workers, about half the total, dropped four percent. Employment has declined for four consecutive years and has reached its lowest level since 1975. We predict that if a ten percent ad valorem tax is imposed on photographic products, this trend will accelerate. None of us would like to see that outcome.

We see a large administrative burden in collecting such a tax, be it at the manufacturers or retail level. In the photographic industry our products can be sold at any of the following outlets: drugstore, supermarket, discount store, department store, camera store, electronics store, chain store, min-lab (drive-in), mail order, and catalog showrooms.[3] As mentioned earlier, it is often difficult to distinguish between a consumer and a professional purchaser.

In summary, photographic products should not be considered a luxury item. People of relatively modest means purchase and use the products of our industry. Excise taxes at the manufacturers level are hidden taxes, are discriminatory, unfair and inflationary. The imposition of the excise tax will adversely affect sales and eventually reduce employment, which is already trending down in the photographic industry.

The administrative burden of collecting such a tax is large, especially if you are dealing in a situation where the amateur and consumer use is very difficult to distinguish from the professional and commercial use.

Excise taxes in this area were recognized by Congress over twenty-two years ago as not such a good idea and were abolished. The passage of time has not invalidated that action. We urge you not to reimpose "luxury excise taxes" on the products of the photographic industry.

We appreciate the opportunity to comment upon this proposal and look forward to an outcome favorable to U. S. consumers. We stand ready to answer any questions that might be raised by our statement.

## REFERENCES

1. 1986-87 Wolfman Report on the Photographic and Imaging Industry in the United States, 825 Seventh Avenue, New York, New York 10019

2. 1987 U. S. Industrial Outlook, U. S. Department of Commerce/ Industrial Trade Administration

3. The PMA Industry Trends Report, 1986, Photo Marketing Association International, 3000 Picture Place, Jackson, Michigan 49201

## Statement of the

# NATIONAL ASSOCIATION OF REALTORS®

## THE WORLD'S LARGEST TRADE ASSOCIATION

On behalf of the more than 730,000 members of the National Association of Realtors, we are pleased to have the opportunity to present our views on the various proposals to increase revenue for purposes of deficit reduction.

We have for several years urged the Congress to address this nation's federal budget deficit. Last year we urged that some of the revenue derived from the tax code restructuring be applied to reduce the deficit. Instead, all the revenue, a large portion of which was from the real estate industry, went to a significant reduction in individual and corporate tax rates.

Deficit reduction continues to be a goal of our Association. We are not unwilling to share in the sacrifice necessary to achieve a gradual narrowing of the deficit. However, housing and real estate investment have already participated to a very great degree in recent spending and taxation changes designed to achieve this, and other, goals. For example, budget authority for the Department of Housing and Urban Development which accounted for over 7% of the Federal Budget at the beginning of this decade is now estimated to be less than 1% of total spending. Moreover, the 1984 tax legislation enacted changes in investment real estate taxation which were, up to that point, very significant tax increases. And, finally, massive new real estate tax increases were imposed as a part of last year's Tax Reform legislation.

Certainly, we were pleased that the mortgage interest deduction for first and second homes was left largely intact last year, as was the property tax deduction. Even so, in our view, the 1986 Tax Reform Act was an unwarranted frontal attack on virtually all of the tax laws affecting real estate investment. Specifically, the Tax Reform Act increased taxes on housing and real estate investment nearly $50 billion. These new taxes included: significantly stretched out depreciation, limitations on the deductibility of "passive losses" from existing and future investments (including all losses from rental real estate even if rental real estate is the principal business of the owner/operator and including all losses even those relating to actual out-of-pocket cash expenses), elimination of capital gains, a virtual repeal of the installment method of reporting the sale of real estate, subjecting real estate to the "at risk" rules, severe limitations on interest deductions, and more.

These tax increases provided a significant portion, and we believe a disproportionate amount, of the revenue required last year to reduce overall individual and corporate tax rates. The magnitude of these new taxes has forced new investment and tax planning strategies for all transactions, not only real estate development, acquisition, operation and disposition but also regarding whether or not to purchase a home.

Those of us interested in providing affordable housing and competitive real estate investment opportunities for Americans are struggling to come to grips with these new rules. In the long run, we are optimistic that our industry can adapt to these changes. However, at this point, new construction for both residential and commercial development is at a virtual standstill and rents for existing housing are steadily increasing. For the typical renter, we estimate that the 1986 Tax Reform law represents an additional rent burden of between 3 and 5 percent of income. This will likely more than offset the benefit a typical renter could have expected from lower tax rates.

Additionally, the rate of homeownership in America is in the midst of the only sustained decline since the 1930's. All income and age groups are affected by this homeownership decline. Among married couples in the 25 to 29 age group, homeownership fell from a rate of 59 percent in 1978 to 52 percent in the first quarter of 1987. For married couples age 30 to 34, the homeownership rate dropped over the same period from 75 percent to 70 percent.

Certainly, the new tax laws are a very real source of unrest in rental housing and commercial real estate markets and they have not helped to stem the continued homeownership rate decline. New taxes on this sector of the economy will disrupt activity even more, leading to further decreases in housing affordability, greater unemployment, additional real estate foreclosures and further strain the nation's already severely weakened financial institutions. Therefore, we feel obligated to inform the Committee as strongly as we can that we do not believe that housing or real estate investment can reasonably be asked to bear another tax increase so soon after tax reform.

The following are our observations regarding specific revenue proposals now before the Committee.

## HOMEOWNERSHIP PROVISIONS

The Joint Taxation Committee presents a variety of revenue raising options in its pamphlet which could increase the after-tax cost of homeownership and/or reduce the value of homes in the hands of existing homeowners. These proposals range from various caps on the amount of debt treated as "qualified residence interest" (including limits on equity lines of credit not only against appreciated home value, but against the equity created by pay down of the purchase note as well) to schemes which would limit all deductions to only the lowest marginal tax bracket.

While the 1986 Tax Reform Act largely preserved the interest deduction for first and second homes, it is important to remember that deductibility was cut back to some extent. Essentially, homeowners may deduct interest on all debt up to an amount equal to the home's purchase price plus the cost of improvements. A taxpayer may also deduct interest on debt secured by the appreciated value of the home if the debt proceeds are used for education or medical purposes. We recognize the policy goal of precluding avoidance of the disallowance of personal interest deductibility. Even so, we feel obligated to remind the Committee that a person's home is generally the largest single asset the homeowner possesses. Therefore, while we understand the reasons for last year's limits, we do not believe that further cutbacks are now desirable.

Regarding proposals to limit individual deductions to the 15% tax rate or to place a floor under all itemized deductions, these would diminish the attractiveness and incentive to homeownership and reduce the value of many homes. Moreover, in addition to decreasing homeownership incentives and arbitrarily reducing the value of many homes, these proposals should be rejected because they would further increase tax complexity for a great many taxpayers.

## WITHHOLDING ON INDEPENDENT CONTRACTORS

The Joint Committee on Taxation pamphlet on revenue options proposes that a new withholding system be instituted whereby persons making payments to independent contractors would be required to withhold 10% of the payment as tax on the independent contractor's income.

Independent contractors perform services in nearly all sectors of the American economy and they operate in all industries, from law and medicine to trucking and logging, from direct sales and insurance to home improvement and construction, from gasoline marketing to entertainment. Inasmuch as there are over 200,000 real estate brokers throughout the country whose salesforce of 500,000 is predominately independent contractors, we know that this proposal would be administratively unworkable and we strongly urge that it be rejected on several grounds.

o REAL ESTATE INDEPENDENT CONTRACTORS COMPLY WITH THE TAX LAWS. This proposal is not a new one. It was last seriously debated by Congress in 1979 when a Treasury Department study purported to show that a large percentage of independent contractors do not pay their fair share of taxes. A review of the record shows that this study was totally refuted because it did not accurately define the universe of independent contractors, the sample size was statistically much too small, and those sampled were not randomly selected. Even so, a detailed analysis of the IRS study revealed that compliance with the tax laws was better than 96% among independent contractor real estate salespeople. In other words, according to IRS's own data, which was skewed to show low tax compliance, at least 96% of the compensation received by independent contractors in the real estate sales profession was reported on their tax returns. We did not see then how tax compliance could be increased through withholding and, as we are unaware of any new compliance study by Treasury, we continue to question the value of imposing withholding on independent contractors. Additionally, over the past several years we have worked with Congress to ensure the this high degree of tax compliance does not diminish. For example, we supported revisions, ultimately enacted, to the information reporting system to require brokers to file IRS Form 1099 (detailing payments made to independent contractors in the ordinary course of business) not only with the IRS but with the independent contractor salesperson as well. We believe that giving the independent contractor information showing the total renumeration received increases tax compliance in all sectors.

o INDEPENDENT CONTRACTOR WITHHOLDING WILL BE AN ADMINISTRATIVE NIGHTMARE FOR SMALL BUSINESSES IN TERMS OF COST AND PAPERWORK. The heavy administrative burden and substantial cost of an independent contractor withholding system would fall to a very large extent, on small businesses that do not already maintain employee withholding systems. This is especially true in the real estate sales industry which is dominated by firms of less than 5 salespeople. Many of these firms do not have any employees, not even a secretary or receptionist, and therefore are unfamiliar with any office withholding system. Forcing these firms to hire an accountant or bookkeeper and incur the additional expenses for paperwork, office space, etc., would obviously impose a new, unfamiliar and costly burden on those least able to survive and compete. In short, it would place yet another bureaucratic paperwork burden, and a costly one, on the small businessperson.

o WITHHOLDING ON INDEPENDENT CONTRACTORS WOULD RESULT IN A TAX ON GROSS--NOT NET INCOME. An independent contractor's income is neither fixed nor guaranteed. An independent contractor has no assurance that his income will bear any relation to the amount of time he devotes to performing his services. He may make several sales presentations and yet not make a single sale; in such a case, he would have nothing to show for all the efforts except substantial expenses. An employee's income, in contrast, is "guaranteed" in the sense that as long as the hours are worked, a specified amount of compensation will be paid. This distinction is very important to real estate salespeople who incur significant expenses in the pursuit of their livelihood. Withholding of tax on payments to independent contractors would thus be a tax on "gross" income not "net", after expenses, income and would create problems of overwithholding of income taxes. While an employee may claim additional personal exemptions on his employee withholding statement to reduce the amount withheld from his gross income, it would be very difficult, if not impossible, for a real estate salesperson to estimate the amount of future business expenses and, thus, the proper number of additional exemptions to claim.

The National Association of Realtors does not condone non-compliance by independent contractors. We believe every person should pay his or her fair share of taxes. However, we urge you to reject this withholding proposal given the high degree of tax compliance by real estate salespeople and the lack of credible non-compliance statistics for others, the heavy cost to small business operations, and the potential cash flow distortions which would likely result.

## ADVERTISING EXPENSES

Among the options listed as revenue raising possibilities by the Joint Committee on Taxation is a proposal to disallow a current business expense deduction for 20% of the costs incurred during a taxable year for advertising costs. Advertising costs are costs of doing business and we urge maintaining the full current business expense deductibility of them.

The tax laws have historically recognized that taxpayers may deduct costs which are ordinary and necessary expenses in carrying on a trade, business or profession. Advertising, whether print or broadcast, is an indispensable part of the real estate sales business. In many cases, it represents the marketing function most responsible for a property sale. It enhances competition for lower, more affordable, real estate prices, as well as providing essential comparative information for potential property buyers. It enables new competing real estate sales businesses to enter markets and existing firms to present properties in new, innovative ways.

The advocates of the "advertising tax" proposals apparently rest their case on the belief that the benefits derived from advertising extend beyond the year of the expenditure and therefore the deduction for such a cost should be deferred to a later year. This belief is mistaken.

First, there is no objective way of establishing the future value of current advertising costs and therefore, any deferral of current deductibility is arbitrary. Second, many costs, (other than those for advertising) which are currently expenses annually by businesses have the potential for providing benefits beyond the year of expenditure. Examples of these expenditures include the cost of training employees, research and development expenditures, the staff and operation costs for corporate public relations departments and legal departments and the salaries and costs of long term planning departments. These expenses are simply different ways of marketing the firms products.

Firms, such as real estate, that rely heavily on advertising, rather than other marketing expenses, would unfairly have their taxes increased due to this proposal simply because of their necessary marketing techniques. Inevitably this proposal would lead to reduced real estate property sales, lost jobs, lower incomes and reduced tax payments by these firms. For the above reasons we urge you to reject any limitation on the full current deductibility of advertising costs.

## FURTHER LIMITATIONS ON INSTALLMENT SALES

One of the least rational amendments made to the tax code by last year's Tax Reform Act was the evisceration of the installment sales method for reporting gain on the sale of business or rental real estate. Prior to the 1986 Tax Reform Act, sellers paid tax on the gain as payments were received. This was changed basically through an elaborate allocation process (known as the proportionate disallowance rule) which treats a part of a seller's existing outstanding indebtedness as if it were an installment payment received on the note. In effect, sellers are taxed in a manner unrelated to actual payments by buyers under a formula which is tilted in favor of wealthy sellers who have few debts and many assets.

Senators David Pryor, John Heinz and David Boren have introduced legislation which will correct this inequitable result. Their legislation, S. 719, would return non-dealers to pre-Tax Reform Act installment sales rules. Gain on installment sales would continue to be taxed. However, taxation would occur, as under the old rules, when payment by the buyer occurred. This would generally stop the taxation of "phantom" income which will result under the Reform act's proportionate disallowance rule. Further, gain from an installment sale would not, under these bills, be subject to the minimum tax. Thus, sellers engaging in a single installment sale would not fear being thrust, solely because of one sale, into the complex minimum tax rules.

Despite the burdensome nature of the proportionate disallowance rule and the efforts to return to pre-Tax Reform Act rules, the Joint Taxation Committee proposes two additional revenue increase options affecting installment sales of real property. First, it is proposed that the installment sales method be repealed directly, rather than indirectly, as occurs now through the proportionate disallowance rule. Alternatively, it is proposed that non-dealers be allowed to defer tax liability until payment is received if interest is paid by the seller on the deferred tax liability.

Approximately 95% of all small business sales and about 25% of all investment property sales involve seller financed installment sales. Installment sales are even more important in rural areas where there are fewer bank financing Options and in high cost areas where seller financing has become an essential affordability technique.

While we believe revisions are necessary in the installment sales area, we strongly urge that you reject the options listed in the Joint Taxation pamphlet and instead urge you to support the Pryor-Heinz-Boren bill, S. 719, which would return non-dealers to the rules that existed before the 1986 Tax Reform Act. Many transactions are currently unable to close because sellers are unable to pay the initial tax liability caused by the proportionate disallowance rule. S. 719 would remove this "phantom income" problem thus enabling transactions to go forward. Gain under S. 719 would continue to be taxed. However, taxation would occur when payment by the buyer occurred.

The proposal to allow a deferral of income tax liability if interest is paid to the IRS is a modest improvement over the proportionate disallowance rule. However, taxation should not occur until payment has been received from the buyer. Therefore, a deferral is not inappropriate and interest assessments against the seller are unwarranted. The truly rational system for taxing installment sales is the system which was in effect prior to the Tax Reform Act.

## MASTER LIMITED PARTNERSHIPS

The pamphlet contains a number of proposals to tax as a corporation either publicly-traded limited partnerships or certain publicly-registered limited partnerships. The National Association of Realtors strongly opposes these proposals for reasons discussed in detail in a statement submitted to the Ways and Means Subcommittee on Select Revenue Measures at a hearing held on Master Limited Partnerships July 1, 1987.

To briefly summarize, the position of the NATIONAL ASSOCIATION OF REALTORS® is that the tax treatment of limited partnerships, including Master Limited Partnerships (MLPs), should be maintained.

## PARTNERSHIP ALLOCATIONS

Another set of proposals contained in the Joint Tax pamphlet would place a variety of additional restrictions on the validity for Federal income tax purposes of special partnership allocations of income, deductions, gain, loss, or credits. One proposal would disallow allocations of income, loss, gain, deductions, or credits that vary during the conduct of the partnership's business. The proposal would require that allocations for tax purposes be in accordance with the partner's interests in the partnership even if the economic substance of the agreement between the partners were entirely different. Other proposals would restrict the use of special partnership allocations for tax purposes where the partnership includes both taxable and tax-exempt partners. One such proposal would require taxable partners to report as income the amount determined by their percentage interest in the partnership even if the amount actually received were loss. Another proposal would permit allocations of losses to taxable partners to be respected up to a threshold percentage (Ex. 35%) if the general percentage interest between the taxable and tax-exempt were followed with respect to other partnership tax items. A variation on this last proposal would require that payments to either tax-exempt organizations or taxable entities on debt or for the performance of services would be taken into account in determining whether partnership allocations had substantial economic effect.

The various proposals regarding partnership allocations that are described above should be rejected for several reasons.

First, a proposal that did not respect an allocation of income, deduction, etc... which varied from the general percentage interest held by each partner would distort the economic terms of the partnership agreement entered into by the parties. For example, if the general percentage interests in a partnership are 90% - A and 10% - B, but A and B split the net proceeds from a sale of partnership property, it would be a distortion of the financial agreement between the parties and would produce an inequitable result if A, who received 50% of the proceeds, were required to recognize 90% of the gain on the transaction, while B recognized only 10% of the gain, but received 50% of the proceeds. On the other hand, if the proposal contained in the pamphlet implicitly is suggesting that a "weighted" percentage be determined for each partner based upon their varying interests in each item of partnership income, loss, etc..., then such an approach would inject considerable uncertainty into the planning of partnership business activities and the tax consequences arising from such activities.

Secondly, because of the prevalent use in real estate partnerships of special allocations to meet the diverse, economic needs of various partners in a real estate transaction, any of the proposed revisions to the partnership allocation rules contained in Section 704(b) of the Code would represent a new, tax increase on investment real estate in addition to the $50 to $60 billion of tax increases imposed on the real estate industry in the Tax Reform Act of 1986. Since it is quite unusual for the development and ownership of rental real estate owned by a partnership not to involve a special allocation of various items of partnership income, loss, etc..., a proposal that caused one or more partners to treat an allocation for tax purposes differently than the economics of the allocation dictates would work a hardship on some partners while creating a windfall for other partners.

Thirdly, the purported justification for the proposals provides that revisions to the special allocation rules would prevent the "selling of tax benefits" among partners. This reference is clearly mistaken. In light of the enactment of the 1986 tax bill, which repealed tax incentives for investment real estate, the ability to "sell tax benefits" by invoking the special allocation partnership rules has been virtually negated. There simply are few, if any remaining tax benefits associated with the ownership by a partnership of rental real estate that can be "bought or sold" through partnership allocations. In short, any perceived tax abuses have been directly addressed in the 1986 tax bill and attempts to alter the tax rules governing partnership allocations would represent overkill.

And finally, the various proposals contained in the pamphlet should be rejected as redundant and unnecessary in view of the revisions to the partnership allocations rules contained in the 1976 Tax Reform Act and the recently finalized regulations promulgated by the Treasury Department under Section 704(b). These regulations, which were issued in proposed form and have been the object of considerable input from tax practitioners, generally require that a special allocation must have substantial economic effect if the allocation is to be respected for tax purposes. Moreover, practitioners have given these regulations favorable reviews from the standpoint of workability and for realizing the legislative intent behind the provision. Accordingly, there simply is no need to revisit an area of taxation, such as partnership allocations, that has only recently been the subject of a thorough and intense study spanning more than three years.

## UNRELATED BUSINESS INCOME TAX-EQUITY KICKERS ON LOANS TO BUSINESS VENTURES

Another proposal contained in the pamphlet would characterize the income received by tax-exempt organizations as unrelated business taxable income

(UBIT) in those cases where a tax-exempt partner receives an equity-kicker in the net profits of the venture.

Current law treats the business income of a tax-exempt organization as unrelated business taxable income (UBIT) if the income is attributable to an equity investment in a partnership. However, an exemption exists from UBIT characterization for passive investment income, including interest and dividends. The proposal in the pamphlet would reverse this result to characterize as UBIT all income received by a tax-exempt organization if the tax-exempt entity has made a loan to the venture and will receive an equity-kicker from the sale or disposition of the partnership or venture property.

This proposal should be rejected for a number of reasons. First, the proposal would deal the real estate industry another serious setback in addition to the Tax Reform Act of 1986, which raised taxes on real estate investment by roughly $50 billion. The practical effect of the proposal would be to deny real estate construction access to tax-exempt lenders, such as pension funds, which make loans to real estate ventures, including multi-family housing projects, shopping centers, and office buildings, but only on the condition that the tax-exempt organization, like most permanent lenders, can receive a percentage of the profits or an equity-kicker on the sale of the property. Because the use of "equity-kickers" is a customary practice presently only in the case of real estate loans, the proposal to tax as UBIT all net income of a tax-exempt lender where an equity-kicker is involved is unfairly aimed at real estate.

Secondly, by causing the tax-exempt entity to pay income tax on the net income characterized as UBIT from a loan with an equity-kicker, the proposal would harm the net retirement for pension beneficiaries. Thus, the proposal runs contrary to the longstanding Congressional policy of allowing retirement income to accumulate tax-free to increase the amount of retirement income available to beneficiaries.

And lastly, the proposal should be rejected as inequitably subjecting tax-exempt organizations to a less favorable standard under the general debt/equity rules of the law than is the case for other lenders who receive equity-kickers. In most instances, a taxable lender with an equity-kicker is treated as a lender for tax purposes and not as an equity holder. The proposal would change this outcome for tax-exempt lenders only by treating all of the net income as business/equity income and not passive investment income exempt from the UBIT.

## TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS

The pamphlet also contains a proposal that would treat a partner who contributes encumbered property to a partnership as if he sold the property to the extent the debt is reduced or retired and cash is contributed to the partnership by newly admitted partners.

This proposal should be opposed on the grounds that it runs contrary to one of the primary objectives behind the 1986 Tax Reform Act, which was to discourage debt-financed purchases of property and to reduce or retire the indebtedness on existing property. By creating the legal fiction of a taxable exchange to the partner contributing property where equity capital contributed by another partner is used to retire or reduce outstanding debt on contributed property, the proposal would discourage the reduction or retirement of debt on existing properties by treating the contributing partner as if he had sold the property in an amount equal to the debt that is reduced or retired. The proposal also departs from the treatment of a partnership as an entity in this area of partnership and instead wrongly treats the partners as if they were dealing directly with each other. Moreover, the proposal could create a liquidity problem for the partner contributing the encumbered property by treating him as if he sold the property without having the cash to pay the tax on the imputed gain. Furthermore, the one situation where such a result may be justified is adequately covered by the step-transaction doctrine of current law - i.e. - where a property is encumbered immediately before its transfer to a partnership.

## PARTNERSHIP-LEVEL INCOME COMPUTATION

A proposal in the pamphlet would revise the tax treatment of limited partnerships to more closely resemble that of a REIT. Under the proposal, income to the partners would be treated as portfolio income and not passive income, while any deductions, losses, or credits generated by the partnership would not pass through to the partners.

The National Association of Realtors submitted a detailed statement on July 1, 1987 in connection with a hearing on Master Limited Partnerships in which the reasons for its strong opposition to this proposal are discussed. However, to chiefly summarize, first the proposal should be rejected as a new, unwarranted tax increase on investment real estate beyond the sizable tax increases imposed on the real estate industry in the 1986 Tax Reform Act.

Secondly, if perceived abuses existed before passage of the 1986 tax bill, adoption of the passive loss limitation prevents taxpayers from deducting tax losses from rental real estate against income other than rental or other passive income. By preventing the deduction of losses from one partnership owning rental real estate against the income from another partnership, the proposal distorts the economic, after-tax effects of a taxpayer who has invested in a number of different partnerships, some of which are profitable and others which are unprofitable.

Thirdly, the proposal to treat rental real estate income owned by a partnership as portfolio income moves in the wrong direction from a policy standpoint. Instead of converting all partnership income from passive into portfolio income, the proposal should treat REIT income as passive income, which present law mandates for rental real estate. Otherwise, this proposal represents a "heads I win, tails you lose" proposition for the Treasury Department regarding the tax treatment of real estate investors, particularly when viewed in conjunction with the aspect of the proposal that denies the pass-through of tax losses to investors.

And finally, if this proposal is accepted, then the resulting entity must have the flexibility that partnerships possess and that REITs currently lack. The REIT attributes which must be avoided include the restrictions on REIT qualification rules, the current asset investment restrictions imposed on the operation of a REIT, and the inability to have different allocations of income and loss to owners which the partnership rules presently allow.

## LIKE-KIND EXCHANGES

One proposal in the pamphlet would prevent investment real estate from receiving the benefit of nonrecognition tax treatment on a like-kind exchange under Section 1031 of the Code. A variation on this proposal would revise the requirements for a like-kind exchange of investment real estate to mandate that nonrecognition treatment will apply only if the properties are similar or related in service or use to each other.

Current law permits an exchange of real estate to be nontaxable if real estate that is investment property or property used in a trade or business is transferred for property of a like-kind. While the like-kind standard permits the tax-free exchange of improved real estate for unimproved real estate, the proposed test requiring that the two properties be similar in service of use would reverse that result.

The proposed revisions to the like-kind exchange rules for real estate should be rejected for a number of reasons.

First, taxation should not be imposed on a transaction in which the taxpayer has not materially altered the form of his investment. A taxpayer who transfers improved for unimproved real estate does not pay tax on this exchange under the current rules (in the absence of cash or excess liabilities). This result is reasonable in view of the fact that the taxpayer has only slightly modified the nature of his investment. Should the fact that improvements have been made on the property transform a nontaxable exchange into one that is taxable? This result makes little sense and should be rejected.

Secondly, the proposal would vitiate a vital technique for the acquisition of investment real estate, especially in times when capital is in short supply and interest rates are high. In many instances, like-kind exchanges are utilized when the parties simply could not afford the costs of paying the tax if a straight sale were made and could not arrange financing through conventional sources. Thus, the effect of such a proposal would be to deter many such transactions to the detriment of the real estate industry and the economy in general.

Thirdly, subjecting a like-kind exchange of real estate to tax could cause a severe liquidity problem for one or more parties to the exchange. Since limited amounts of cash may be involved in a like-kind exchange, the proposal could cause one or more parties to pay a tax on the exchange without the cash to make the tax payment.

## INDIVIDUAL CAPITAL GAINS

The pamphlet contains a proposal to tax net, long-term capital gains for individuals at a maximum rate of 15 percent. The Tax Reform Act of 1986 repealed the capital gains exclusion, beginning in 1988, causing gain from the sale of investment assets or income-producing property to be taxed at ordinary income rates. The NATIONAL ASSOCIATION OF REALTORS® offers strong support (with a caveat noted below) for restoration of a lower tax on the sale of investment assets or income-producing property for reasons discussed below.

First, a lower tax on the sale of investment assets or income-producing property would promote economic growth by encouraging the sale of appreciated assets. Evidence based on the effects of the lower capital gains tax rates enacted in 1978 and 1981 suggest that lower taxes on the sale of so-called capital gains assets will provoke a flurry of sales activity that could lead to increased tax revenues for the U.S. Treasury.

Secondly, the current tax treatment of gain from the sale of capital gains assets subjects "inflationary" gain to the ordinary income rates, which tends to cause investors to hold onto their assets for a longer period than would otherwise be the case. A tax on capital gains assets that is lower than the ordinary income has always been justified in part by a recognition that gain on the sale of an asset was partially a function of inflation during the years that the asset was held. To tax inflated gain at ordinary income rates will stem the flow of capital into investment properties and slow down economic growth. Conversely, a lower tax on the sale of capital gains property would provide an incentive to investors to engage in risk-taking ventures that promote employment and financial activity.

However, the NATIONAL ASSOCIATION OF REALTORS® is concerned that the rules concerning recapture of depreciation on the sale of income-producing real estate that were part of the law prior to the 1986 Tax Reform Act be reinstated if a lower capital gains rate is adopted. Under prior law, gain on the sale of income-producing real estate was taxed as a capital gain if the seller had elected to depreciate the property using the straight-line method. If an accelerated method of depreciation were elected, then the seller was taxed at ordinary income rates up to the amount of gain on the excess of accelerated depreciation over straight-line depreciation. Since the 1986 tax bill allows only straight-line depreciation over a longer recovery period than previously was the case, enactment of a lower capital gains rate, such as a 15 percent maximum, should be coupled with a proposal to tax as capital gain all appreciation on income-producing real estate in excess of the property's basis.

## REPEAL OF THE "STEPPED-UP BASIS" RULE

The pamphlet contains a number of proposals that either repeal or severely curtail the rule under present law concerning the basis of property passing to the heirs from a decedent's estate. Current law provides that the basis of inherited property is "stepped-up" to the fair market value on the date of the decedent's death. The proposals would either tax the appreciation in property at death or allow the heirs to receive a carryover basis equal to the basis that the decedent had in the property prior to his demise. One proposal would tax the appreciation at death in excess of the basis, while granting a credit against the tax for any unused portion of the decedent's unified estate and gift tax credit. A variation on this proposal would provide a partial credit against any Federal estate tax owed by the estate for the basis of the decedent's property includible in his gross estate. However, this proposal would be coupled with an increase in the estate tax rates in order to achieve revenue neutrality. Another proposal would provide a carryover basis for property passing to the surviving spouse, while other appreciated property would be fully taxed. The proposal requiring a carryover basis for inherited property is presumably modeled after the carryover basis provision that was adopted as part of the 1976 Tax Reform Act and repealed in 1980.

The proposals to either tax at death the appreciation in the value of property in excess of basis or to require a carryover basis for inherited property should be rejected for several reasons.

First, the proposals to tax appreciated property at death could cause a dire liquidity problem for many estates which have properties possessing substantial appreciation. A proposal, which causes estates that owe significant estate tax liability to pay a further tax under the Federal income tax laws for appreciated property, could lead to sales of property simply to generate the cash to pay both taxes. Moreover, such a proposal could work a severe hardship on family farms, which quite often are "land-poor" with properties having values in excess of basis and little cash to pay either the estate tax or any new tax on appreciation.

Secondly, the proposal to provide a carryover basis for inherited property represents a feeble attempt to resurrect a thoroughly discredited proposal that was briefly a part of the law in the late 1970s. The carryover basis provision, which was adopted as part of the Tax Reform Act of 1976, required an heir to use the basis, with certain adjustments, that the decedent had in property before his death. The appreciation in value of the property would be taxed upon a subsequent sale of the property by the heir. The carryover basis provision was so unpopular that the effective date of the provision was deferred by legislation in 1978 and then subsequently repealed by legislation enacted in 1980.

There is no reason to believe that the carryover basis proposal has gained any wider acceptance since its repeal in 1980. In fact, the reasons for its short life at that time are even more valid today. Foremost among those reasons is the "lock-in" effect that the carryover basis creates. If property possesses substantial appreciation, the carryover basis can cause an heir to hold on to property beyond the normal holding period for an asset simply to avoid payment of a substantial tax on the sale of appreciated property. This statement is even more true after passage of the Tax Reform Act of 1986, which repealed the capital gains exclusion and imposes an even higher tax on gain from the sale of appreciated assets. Moreover, the "lock-in" effect caused by the carryover basis provision distorts the investment decisions and marketing patterns of investors and should be rejected.

## TAX EXEMPT ORGANIZATIONS

In addition to the proposal discussed on page 8 regarding tax exempt organizations' loans to business ventures, the Joint Taxation Committee pamphlet proposes to subject additional trade association revenue sources to the unrelated business income tax (UBIT). A variation on this proposal is to impose 5% excise tax on the net investment income of all tax-exempt organizations including trade associations.

We do not support either of these proposals.

First, in order to raise income in order to carry out the tax exempt mission of trade associations, groups have turned to many activities, in addition to membership dues. Among the activities which trade associations now charge fees for include: Meetings and seminars, trade shows, periodicals, etc. In addition, many trade associations attempt to build a reserve of funds for future growth, as well as for survival during economic downturns. Subjecting this investment income to UBIT or imposing an excise tax will surely impede the trade association's mission.

Quite clearly, trade associations that derive income from activities unrelated to their exempt purpose pay tax on that revenue. It is also clear, we believe, that allegations of "unfair competition" by some in the small business community do not pertain to trade associations. Therefore, we do not believe changing the UBIT statute to subject to UBIT some types of income -- solely because of their source -- is warranted or desirable.

# Written Statement
of
The National Association of Truck Stop Operators
before
The Senate Finance Committee
on
Revenue Options
particularly
Collection of Federal Excise Tax
on
Diesel Fuel

The National Association of Truck Stop Operators (NATSO) appreciates the opportunity to submit comments on the revenue options currently under consideration by the Senate Finance Committee. NATSO is the national trade association of the truck stop industry representing some 1500 facilities located on interstate and major highways across the continental United States. NATSO members constitute a majority of the full service truck stops providing most of the highway fuel, food, lodging, repair and other related services for the interstate trucking industry as well as for the motoring public. Their role in the marketing of diesel fuel is quite important, since truck stop operators sold approximately 12 billion gallons of diesel fuel for highway use in 1986, out of a national total of 18 billion gallons.

## I. Background

Under the Tax Reform Act of 1986 (P.L. 99-514), federal excise tax on diesel fuel is collected either by the retailer at the point of sale or by the wholesaler at the time the retail operator purchases, if the retailer so elects. This optional collection procedure then, means that the federal government collects in turn from either point in the marketing chain. Before 1986, the collection and remittance had always been by the retailer.

In its "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means", the staffs of the Joint Committee on Taxation and House Ways and Means Committee suggest that one option would be to make mandatory the collection of the excise tax upon sale by the wholesale dealer. It is this proposal which NATSO opposes.

## II. The Current System of Collection of Diesel Excise Taxes is Adequate if Properly Enforced

NATSO recognizes the important need to collect all taxes due to the federal government. Furthermore, it strongly agrees that collection of current taxes is preferable to imposition of new or increased excise taxes to help produce revenue. However, there currently exists a degree of misunderstanding regarding the base of businesses from which diesel excise taxes are being collected.

It has been estimated by some that the current system has created 100,000 points of collection for the diesel excise tax. In fact, the Internal Revenue Service estimates this number to be closer to 70,000-80,000, but even this number requires clarification. The majority of diesel fuel for highway use is sold by full service truck stops along the interstate and federal highway system. At the most liberal estimate, there are only approximately 2700 such retail outlets, most of which sell over 100,000 gallons of diesel per month, totalling 2/3 of the 18 billion gallons of diesel fuel sold annually. Thus, 12 billion gallons of diesel are sold annually at retail by just 2700 truck stops. NATSO submits that this is certainly a manageable number of taxpayers for the IRS to audit, and along with approximately 8000 wholesalers, significantly reduces the number of reporting entities who would need to be audited.

The truck stop industry encourages full enforcement of the tax laws, and wants to see that there is accurate collection of diesel excise taxes. To that end, representatives of NATSO have met with the staff of the Internal Revenue Service and the Federal Highway Administration to express their willingness to assist in the redesign of a Form 720 to achieve a more accurate, verifiable form for remittance of the tax to the federal government.

Besides better audit records, improved enforcement would dramatically increase the revenue raised by the existing diesel excise tax, eliminating the need for a change in the point of collection of the tax. For example, a limited project was conducted last year between the IRS and five participating states exploring the effectiveness of cooperative collection of excise taxes. The results were dramatic. The joint audits led to recoveries of $1.8 million in tax and penalties from just 25 remittors of diesel fuel taxes. This represents some $3,000 per audit hour. NATSO believes these joint audits should be undertaken across the board, and has encouraged other state tax officials to participate in the future. Indeed, joint audits are only one of the efficient ways in which enforcement could be enhanced. Given the proper tools, the IRS should examine closely the adoption of better enforcement methods covering diesel tax areas fraught with potential abuse, such as diesel marketing on Indian reservations, diesel sales to truckers by farm cooperatives and keylock and cardlock operations.

## III. Where Evasion or Non-Remittance of Diesel Taxes Exists, it is Primarily from Small Retail Sellers

Accepting the IRS's estimate of 70,000-80,000 reporting entities selling diesel fuel, NATSO recognizes that there may be some 70,000 outlets other than major truck stops selling diesel fuel. Each of these outlets are currently responsible for the sale of a very small portion of the taxable highway fuel sold, totalling only 1/3 of the annual total. NATSO contends that where non-remittance of diesel taxes exists, it is largely from these outlets. Some of them, who primarily sell gasoline or home heating oil, may not be aware of the necessity to remit the tax on diesel sold for highway use. Others are participating in schemes to evade paying these taxes.

Therefore, NATSO would support the mandatory collection of diesel taxes by the wholesaler from those retailers selling less than 100,000 gallons of diesel fuel per month as a way of decreasing the number of points of collection. This would leave approximately 2,700 retailers across the nation from which to collect the tax, who would account for the majority of diesel fuel sales. NATSO also recognizes that under this collection there would be other entities, such as major trucking companies and fleet operators who would potentially meet the threshold of 100,000 gallons sold per month. The number of these non-truck stop businesses however, is probably not above 100. Additionally, another 8,000 wholesale distributors would account for the remainder. Thus, the entire diesel tax collection system would be reduced from 80,000 points of collection to approximately 10,800. Most of those businesses, who are represented by NATSO and the Petroleum Marketers Association of America, are committed to improved enforcement in order to protect a fair and competitive environment in their industry.

## IV. The Current System of Tax Collection was Designed as a Fair and Reliable System, and Should be Allowed to Work

The Tax Reform Act of 1986 was intended to provide a more equitable system of tax collection. Where options were provided, such as in the collection of diesel taxes, they were done so with the intention of providing flexibility within the system. The current system provides truck stop operators the option of taking advantage of collecting the tax from their customers and remitting it to the government or paying it to the wholesaler so that they do not bear the burden of reporting. This option is of great importance to these small businesses, particulary because of the cash flow that is created.

It was a clear intent of the Congress to enact a system on which taxpayers could rely and depend. While estimates have been put forth that the proposed change in diesel tax collection might produce some $400 million dollars in increased revenue, it is impossible to support that figure with concrete data regarding the specific source of the revenue. In fact, it has been shown that much of that increased revenue can be generated by better enforcement procedures. To change the point of collection of all diesel taxes now, absent any demonstration of need, is not only unfair but unnecessary, and would thwart the Congressional intent.

Furthermore, the optional system for remittance of excise taxes has been in existence less than one year. The quarterly form used in reporting diesel tax was only issued in April. The IRS is currently reviewing revision of the Form 720, and is considering promulgation of detailed regulations under the statute and other measures for more efficient enforcement. These efforts are occuring with input from and the support and cooperation of the truck stop industry. Therefore, NATSO encourages this Committee and the Congress to allow the current system to work as it should before legislating widespread changes.

## V. Summary

In conclusion, while some limited evasion of remittance of diesel excise taxes is occuring, such evasion does not justify the complete overhaul of the collection system. Estimates of huge new revenues brought about by such an overhaul are exaggerated and speculative, at best.

Ongoing efforts by the Internal Revenue Service and the Federal Highway Administration to improve collection should be encouraged and allowed to continue. The truck stop industry, the major sellers of highway diesel fuel in the country, will continue its cooperation in the development of more effective enforcement procedures.

If adjustments are to be made, they should concentrate on the segment of the distribution system where problems are most likely to occur, the retailer of small quantities of diesel fuel. NATSO supports the movement of the collection from retailers of less than 100,000 gallons per month to wholesalers in order to provide a more manageable base of collection. Combined with better enforcement procedures, a system limiting collection to 2,700 truck stops and 8,000 wholesalers would give the IRS better control, resulting in the collection of proper revenues.

Therefore, the total revision of the system of collection set forth as an option for raising revenues is unwarranted. This Committee and the Congress should not be misled into the belief that such a drastic modification is needed to raise additional revenues and reduce the deficit.

## NATIONAL AUTOMOBILE DEALERS ASSOCIATION

## COMMENTS ON REVENUE OPTIONS

As the markup on revenue options approaches, the National Automobile Dealers Association ("NADA") is becoming increasingly concerned about the prospect of the adoption of certain new anti-consumer and anti-small business tax provisions. The three proposals we are most concerned about are (i) the proposal to impose an excise tax on a portion of the cost of certain automobiles; (ii) the proposal to require amortization of a part of a taxpayer's advertising costs; and (iii) the proposal to repeal the stepped-up basis at death rules.

### Proposed Excise Tax on Certain Automobiles

NADA is opposed to the proposal to impose a 10% excise tax on a portion of the cost of automobiles priced in excess of $20,000. This tax would increase the cost of these automobiles, which would have a negative impact on sales and on the economy as a whole. When prices are driven higher by the imposition of this excise tax, sales will undoubtedly be affected and workers' jobs endangered. This is an especially serious issue since one of the industries the Committee has targeted, the automobile industry, employs, directly or indirectly, nearly one-sixth of the American work force.

NADA is especially troubled by this proposal because it targets the automobile business. During the past several years, Congress has enacted a number of tax provisions that have hurt retail automobile sales in this country. First, with the so-called "luxury" car provisions, Congress singled out cars used in a trade or a business and denied them the favorable treatment afforded other tangible assets used in a trade or business. (The cars affected by this provision include low and moderate priced cars.) Second, despite the fact that for virtually all Americans an automobile is a necessity and not a luxury item, in the Tax Reform Act of 1986 Congress denied consumers the benefit of the interest deduction for interest expense incurred in connection with the purchase of an automobile. (At the same time, Congress permitted wealthy individuals to deduct interest on vacation homes.) NADA recognizes that given the magnitude of the nation's budget problem, every sector of the economy must give up its fair share. NADA, however, strongly urges the Committee to recognize the costs recent tax legislation has already imposed on America's consumers and automobile dealers.

Finally, NADA encourages the Committee to recognize that a $20,000 car is not really a luxury item that should be subject to a luxury tax. The average price of a full size Chevrolet station wagon, a typical family car, approaches $20,000. For most Americans, this type of automobile is a necessity, not a luxury.

### Proposed Limitation on Deductibility of Advertising Expense

NADA similarly urges the Committee to reject the proposal to require that part or all of a taxpayer's advertising costs be capitalized and amortized over some period of time. The proposal is based on the premise that the benefits derived from advertising extend beyond the year of the expenditure. This premise, at least as regards automobile dealers, is fundamentally wrong. NADA submits that advertising costs are costs of selling a product in the year in which the product is sold. In the highly competitive automobile business, advertisements focus on the product that is currently available and the price of that product at the current time. In this highly mobile society, with consumers purchasing cars on average only once every four to five years, it would make little sense for a dealer to spend advertising dollars on the long term benefits of doing business with it time and again. Thus, at least from an auto dealer's perspective, implementation of the proposal would amount to a partial transformation of the corporate income tax from a net income tax to a gross revenues tax without a corresponding reduction in tax rates. Obviously, this would result in a huge, disproportionate tax increase for most dealers.

NADA also urges the Committee to consider the impact of the adoption of this proposal on the American consumer. First, it would increase the cost of all automobiles regardless of price or luxury. In other words, from the perspective of the consumer, the adoption of the rule would represent the imposition of a regressive tax by increasing the cost of a necessity. Second, advertising provides important benefits to consumers by making them better aware of the products that are available in the marketplace and the price they should pay for such products. Tax rules that serve as a disincentive to advertise ultimately would limit consumer access to important information.

## Proposed Elimination of the "Stepped-Up Basis" Rule

Finally, NADA submits that the alternate proposals for repeal of the "stepped-up basis" rule for property transferred at death should be rejected. First, the present system of "stepped-up basis" is workable. In contrast, the system that would result if a carryover basis rule is adopted would not be workable. Property passing at death may not be sold until years after such death. At that time, the calculation of the basis of the property would depend upon the existence of records of expenditures made by the decedent over the years. Few persons are in the habit of maintaining these kinds of records. Moreover, even if adequate records existed, there is no reason to believe that the taxpayer would have access to such records. In the absence of records, determining the basis of the decedent's property would prove virtually impossible. The same problem arises if the current rule is repealed in favor of one requiring recognition of gain at death; proper measurement of gain will turn on records that are not likely to be readily available.

More importantly, if a rule requiring recognition of gain at death is adopted, and the transfer of business property at death is subject to double (income and estate) taxation, the ability of families to transfer small businesses from generation-to-generation and keep such businesses both viable and in the family would be severely limited. NADA submits that the issue here is whether the Congress should discourage the transfer of family businesses from generation-to-generation. If not, the proposal to repeal the current stepped-up basis rule should be rejected. NADA strongly urges the Committee to recognize the important role that family businesses play in our society and reject the current proposal.

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NADA also notes that the Committee is considering a provision that would treat trade associations like social clubs for purposes of the Unrelated Business Income Tax ("UBIT"). NADA urges the Committee to clarify the proposal and ensure that income from legitimate conventions attended primarily by trade association members will not be subject to UBIT. Since there is no logical distinction between membership fees paid by members and amounts paid by members at conventions for services provided by the trade association that are consistent with its exempt purpose, this clarification would not alter the intent of the proposal, but would provide trade associations only deriving income from the provision of related services to members with clear guidance as to the application of the proposal.

# Written Statement

of the

# NATIONAL CATTLEMEN'S ASSOCIATION

on

Possible Options to Increase Tax Revenues

by

James L. Powell, Chairman
NCA Tax and Finance Committee

Mr. Chairman and members of the Committee my name is James L. Powell. I am a rancher from Ft. McKavett, Texas, and chairman of the National Cattlemen's Association Tax and Credit Committee. We appreciate the opportunity to submit written comments to this committee and share our views on options to increase tax revenue. The National Cattlemen's Association represents farmers and ranchers nationwide through direct membership in our association and through various affiliated state associations.

Agriculture and the cattle industry are undergoing some very difficult and changing economic times. My ranch is located in southwestern Texas, and I have been actively involved in farming and ranching all my life. As a cattleman and a businessman, I recognize the importance of a fair and equitable tax code, and the necessity to balance the budget and eliminate deficit spending. Our association has been very active on tax issues for many years, and we appreciate this Committee's invitation to once again share our views on very important tax considerations which will affect the cattle industry. Our commitment to deficit reduction is evidenced by involvement in the push for a balanced budget.

Over the last three years, our organization worked closely with members of this committee and its staff to ensure that tax reform was fair, equitable and returned business decision-making back to economics. The 1986 Tax Reform Act was one of the largest tax acts ever passed. Statements were made by various members of Congress during the consideration of this massive tax overhaul that there should be no further changes for some time in order to let the provisions of the Tax Reform Act of 1986 work, be understood, and be implemented. To make substantive changes would be unfair and would emphasize the perception of instability in our tax laws.

There is one extremely burdensome provision that needs to be corrected soon to carry forward the theme of the TRA of 1986. The new preproductive expensing rule is unfair and unnecessary. We are working with members of this committee to address this problem in a revenue-neutral manner.

The NCA feels strongly that the economic situation of deficit reduction should be addressed by systematic, substantial reductions in federal spending. If additional revenues must be generated, Congress and the Administration should look first toward the improvement of compliance and collection procedures. Then, and only then, should attention be focused on the revenue side. Consideration of a broad-based consumption tax should be the first focus because such a tax does not penalize savings and investment, unlike increased income or estate taxes. Also, any type of luxury or excise tax should not in any way apply to property primarily designed for business use.

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The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle industry--including cattle breeders, producers, and feeders. The NCA represents approximately 200,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 18 affiliated national breed organizations.

I would now like to focus on specific areas outlined in the recent publication entitled Description of Possible Options to Increase Revenues, prepared for the Committee by the staff of the Joint Committee on Taxation.

## Estate and Gift Tax Laws

In 1981, major changes in estate and gift tax laws were made by Congress. These changes have had a very positive and significant impact on allowing family farmers to pass illiquid assets in a family business to future generations of farmers and ranchers without tax burdens, which would cause the operation to be broken into units that are not economically viable.

To make changes in this area would be improper and cause major restructuring of estate plans by farmers and ranchers. Lawyers would be the beneficiaries. The ability to implement an effective and fair estate plan is dramatically affected by each change in the estate and gift tax laws. Each time the rules of the game are changed, it requires our members to once again review their estate plans to ensure they are in compliance.

Estate tax rates and unified credit should not be altered. The value of farms and ranches obviously fluctuates and appreciates at different rates. However, any changes in this area at this time would have a very disruptive and potentially burdensome effect on the ability of farmers and ranchers to pass on an economically viable operation to the next generation. In addition, many small and mid-sized family operations are undergoing severe economic times, and to impose the burden of additional estate taxes would have a very damaging effect on an already acute cash flow situation.

Treating death as a taxable sale of property and requiring appreciated assets to be subject to income tax would be catastrophic to farmers and ranchers. Death is a very inopportune time to impose a tax on a family which is trying to keep the operation together.

The carryover basis rules in the revenue proposal are unworkable, as was discovered in 1978 when the Carter Administration proposed such legislation. To deny minority discounts overlooks the recognized practice of valuing property interest at fair market value. The extensive record-keeping burden that this would impose on farmers and ranchers would be extremely difficult to comply with, and would be unfair. These records would be difficult--if not impossible--to locate in the decedent's estate and be maintained by the heirs.

## Cash Method of Accounting

More than 90 percent of all farmers and ranchers use the cash method of accounting. With the loss of income averaging in the 1986 Tax Reform Act, cash accounting remains the only viable way for farmers to average out income from year to year. The cattle business is a very volatile business, with factors such as price, weather and an entire host of other economic considerations causing income to fluctuate greatly from year to year.

The 1986 TRA and previous tax acts clamp down on the use of cash accounting by farming syndicates and others not engaged in farming or ranching on a bona fide basis. To restrict the use of cash accounting by bona fide farmers and ranchers, regardless of their income level is not warranted and would be divisive and create unfair competition. Arbitrary restrictions or caps that are placed on the use of cash accounting are unfair, restrictive and disregard economic considerations.

## Restrictions on Farm Losses

The proposal to limit the deductibility of all farm losses and treat those as passive losses, similar to real estate, ignores the major differences between farming and real estate. Farming and ranching is a very capital intensive business requiring high-leverage positions and utilization of all types of capital. Loss limitations for those actively involved in farming and ranching ignores the fundamental economic realities of agriculture and builds a wall around our industry that is economically unhealthy.

The 1986 TRA and prior acts eliminated farming as a tax shelter. To restrict losses of bona fide farmers and ranchers would make it very difficult to continue agriculture operations where many farmers and ranchers have diversified to supplement their income by part-time employment off the farm. NCA supported efforts by this committee and Congress to curtail abuses of tax laws. We encourage you to recognize the damaging effect that a restriction of the deductibility of farm losses would have on agriculture.

## Income Tax Rates

The 1986 Tax Reform Act established tax rates, exemptions and deduction amounts which should not be changed. The phase-in, as promised in the 1986 TRA, should be allowed to come into effect. There should be no reduction in deductions allowed by this Act, such as soil and water conservation expenditures. Like-kind exchanges should be permitted as under current law and no changes should be implemented. Such exchanges are frequently used by farmers and ranchers for business and economic reasons. To tax such exchanges would impose a liquidity problem.

Furthermore, no limitations should be applied to installment sales contracts, since such sales were significantly curtailed and restricted in the 1986 TRA. In addition, a corporation using the LIFO method of valuing inventories should be permitted to elect "S" corporation status without being required to include in income the LIFO recapture amount. The current provision on excluding income for meals and lodging provided to employees on an employer's premises should be continued.

## Energy Consumption Tax

A broad-based energy consumption tax would be particularly harmful to agriculture which uses large amounts of energy in producing food and fiber. This type of tax would almost certainly increase the cost of production and ultimately the cost of food. At some point, this type of tax would be passed on to the consuming public. Farmers and ranchers are at the beginning of the food chain and such taxes would impose another cost to the producer at a time when many are struggling to stay in business.

## Value Added Tax (VAT)

The cost of implementing a VAT and its impact on commercial transactions should be carefully examined and considered. The 1984 Treasury Report should be updated. Although a tax would likely raise significant revenues, the time and cost of administration and the widespread impact it would have should be carefully evaulated. In no case, should necessities such as food be included in such a tax.

## Taxing Trade Associations

Trade associations use income from investments to carry out their exempt purposes and such income should not be taxed. This income is a vital source of funds to trade associations. The unrelated business income tax imposed on social clubs cannot be likened or equated to trade associations. This analogy is incorrect and fails to recognize the very important role and economic purpose that trade associations play to businessmen such as farmers and ranchers.

## Conclusion

We recognize that this Committee has a very difficult task of determining how to meet budgetary goals and achieve effective deficit reduction. As we stated earlier, primary attention must focus on reduced spending, and taxation should be resorted to only if all other methods and avenues have been exhausted.

Certainty and stability in tax laws are vital so that agricultural producers can make wise economic decisions and plan ahead. The recent tax reform debate, promised fairness, lower tax rates and a level economic playing field. These are still very much in the minds of those who worked with you in achieving significant and positive tax reform. To abandon those ideals and goals by making additional changes and not scaling down tax rates which would send the wrong signal to those who supported tax reform in 1986.

# STATEMENT OF THE
# NATIONAL COUNCIL OF SAVINGS INSTITUTIONS
# COMMITTEE ON FINANCE
# UNITED STATES SENATE
# ON
# REVENUE INCREASE OPTIONS

AUGUST 17, 1987

The National Council of Savings Institutions appreciates the opportunity to submit for the record its comments on revenue increase options outlined in the Joint Committee Pamphlet, "Description of Possible Options to Increase Revenues", June 25, 1987. The National Council is a trade association representing approximately 600 savings banks and savings and loan associations with total assets of $450 billion. Our members include both FDIC and FSLIC-insured institutions.

## INTRODUCTION

Members of the National Council are concerned over a number of the options outlined in the Joint Taxation Committee publication on revenue raising options. These include the following proposals: 1) Limitations on the deductibility of interest for home equity loans; 2) Modification of the treatment of recoveries of foreclosed property; 3) Changes in the amortization of intangibles such as core deposits of financial institutions; 4) Reduction of the dividends received deduction; 5) Imposition of a 30 percent withholding tax on interest income paid to foreign investors; and 6) Imposition of a securities transfer tax (STET). Other issues outlined in the document may be of concern to members of the National Council, but are under study at this time.

While the specific issues of concern will be discussed below, we would like to express a general observation regarding tax legislation. Members of the National Council would prefer to see the development of very few new tax changes in 1987. First, the thrift industry is still in throes of restructuring and needs the stability to complete that restructuring. As members of this Committee know, there are many problem institutions to be dealt with. The legislation to restructure the Federal Savings and Loan Insurance Corporation (FSLIC) is near completion. While tax changes may not directly affect the restructuring, any change (particularly negative ones) creates confusion and diverts resources. Further, the thrift industry is (as are other taxpayers) still adjusting to the massive changes contained in the "Tax Reform Act of 1986". Our members are still involved in strategic planning to incorporate the provisions of this landmark Act and, in fact, are still awaiting many of the regulations which will implement this Act. Taxpayers need time to incorporate the current changes without worrying about modification of the rules. For these reasons, we urge the Committee to be judicious as it develops reconciliation legislation.

## DEDUCTIBILITY OF INTEREST ON HOME EQUITY LOANS

One of the options contained in the Joint Taxation Committee print relates to the deductibilty of interest on home equity loans. The document lists five options for limiting the deductibility of interest on home equity loans. While some of the options may be preferable to others, the National Council would urge the Committee not to repeal or limit the deductible status of this interest. We do this because we believe this is a product that allows middle class taxpayers to tap the equity in their home for worthy purposes without incurring the trouble and expense of selling their home or of filing separate loan documents for each transaction. Home equity loans provide flexibility to both the homeowner and the lender to structure loans which meet the specific goals of the homeowner. For our members home equity loans are good products and we believe we can market such loans regardless of the tax status. We express our concern, however, because the customer finds the deductibility of the interest on such loans to be desirable.

While we urge no action on this item, we would like to share our thoughts and concerns on the structure in the event the Committee feels it necessary to modify the provisions enacted last year. First, any structural changes should result in increased simplicity for the taxpayer and the lender. Option five which would deny the deductibility for boats and mobile homes as second residences would be an administrative nightmare for the Internal Revenue Service as well as the consumer. Second, changes should not stifle the innovation of the marketplace in developing products. Option three which limits deductions to home equity loans with a fixed term would stifle products designed to provide convenience and lower costs to the homeowner. In addition, such a provision would increase confusion for the taxpayer. Option one would arbitrarily change the rules homeowners have depended upon and would be difficult to administer.

## RECOVERIES OF BAD DEBTS OF THRIFT INSTITUTIONS

The publication outlining revenue options includes a provision which would modify the treatment of recoveries of bad debts by thrift institutions. Under the proposal, amounts realized upon the disposition of property acquired by foreclosure or property which was used as security for a loan would be attributable to the bad debt reserve only up to the institution's basis in the loan. Amounts in excess of basis would be taxed as ordinary income. The National Council would oppose this change. As we indicated in the introduction to this statement, thrift institutions are in a period of restructuring and are working to solve the difficulties created by problem institutions. Given this scenario and the current difficulties in disposing of foreclosed property in many localities, we do not believe it is the time to modify these rules. If the committee believes modifications in this area are necessary, we will be happy to discuss possible alternatives.

## AMORTIZATION OF INTANGIBLES

Item 6.i. of the Revenue Options pamphlet deals with an area of great complexity. This relates to the tax treatment allowing amortization or depreciation of intangible items. The pamphlet contains possible proposals which would deny amortization deductions for intantigible assets representing the value of the existing customer base or market share or, as an alternative, would permit amortization of such intangible assets only over a prescribed period of substantial duration. One of the intangible items affected by this provision are the core deposits of financial institutions.

The core deposit question has been one of long-standing controversy. The National Council believes that this controversy is unfounded. The Financial Accounting Standards Board (FASB), and the banking regulators have recognized core deposits as separate from goodwill. Core deposits have value as a future income stream. In acquisitions, mergers, branch purchases and other similar transactions, core deposits have value which is paid for and a useful life which can be determined. It is possible to look at the history of the deposits of an entire institution or branch and determine the stability of the deposits, the rate of interest paid on deposits and develop an estimate of what the value of the deposits to the acquiring institution would be. Core deposits are distinguishable from goodwill and have a reasonably estimable useful life.

Currently, there are a number of acquisitions and mergers of financial institutions occuring. This is especially true of the thrift industry as it works it way back to profitability. An additional part of the streamlining process includes sales of branches which do not fit into a particular institution's plan or operations. In these transactions a value will be placed on and a price paid for certain deposits and an amortization deduction should be allowed for any expected future decline in the customer base. To require a lengthening in the time period over which the attrition in the core deposits must be amortized, places tax policy directly at odds with book and regulatory requirements under which institutions must write off these costs over a shorter period of time.

## DIVIDEND RECEIVED DEDUCTION

One of the options contained in the Joint Taxation Committee Print relates to the dividends received deduction allowed under current law. The pamphlet suggests that the deduction could be limited for newly issued stock that does not rise to level of direct investment in the underlying business or, alternatively, the current 80 percent deduction could be substantially reduced. The National Council would question the wisdom of making such a change and suggests a close evaluation of the impact. This is especially true given the fact that changes were made in this area as recently as the Tax Reform Act. Given the concerns over capitalization of a number of companies, including thrift institutions, and over the already existing double taxation of corporate income, we urge retention of the dividend received deduction.

## IMPOSITION OF A WITHHOLDING TAX ON INTEREST PAID TO FOREIGNERS

The "Description of Possible Options To Increase Revenues" contains a proposal to reinstate a withholding tax on U.S. interest paid to foreign investors. While the document includes no recommended level of withholding, until 1984 there was a withholding tax of 30 percent on such interest. The National Council strongly opposes any reinstatement of the withholding tax on interest paid to foreign investors.

The National Council members oppose the reimposition of this withholding tax because it would adversely affect the ability of our member institutions to raise funds in the international capital markets. Such foreign investment has allowed thrift institutions to sell mortgage-related debt at attractive rates. Reinstatment of the withholding tax would force thrift institutions and other corporate borrowers to compete only in the domestic market. This would result in higher domestic interest rates and increase the cost of funding mortgage portfolios. The critical nature and sensitivity of the international markets was dramatically demonstrated following the June 29 announcement by the U.S. Treasury Department that it was terminating the Netherlands Antilles Treaty. There was an immediate drop in the price of all offshore bonds and an immediate freeze in the trading of savings institution bonds outstanding. We do not believe reimposition of the tax or other disruptions of the market are desirable at this time.

## SECURITIES TRANSACTION EXCISE TAX

One of the options discussed in the Joint Tax document on revenue raisers and one which has received a great deal of publicity is the possibility of imposing a securities transfer excise tax (STET). The proposal suggests that such a tax could be assessed at a level of 0.5 or 1.0 percent of value upon transfers of certain securities. While the document does not outline the technical workings of a STET, the National Council is concerned over the possible structure and reach of any provision which would be imposed. Our concern is two-fold. Many of our member institutions are converting from mutual to stock in order to increase capital to meet regulatory net worth requirement? The imposition of a STET at this point would raise the cost of obtaining capital and could, depending on the structure, make it more difficult to sell the stock of thrifts. Secondly, we would be concerned over the imposition of the transfer tax on mortgage-backed securities and other vehicles used by the thrift industry to fund home mortgage lending. Further, our members would be concerned over the reach of a securities transfer tax in terms of its extension to a wide range of investment vehicles in the name of equity.

The National Council would also be concerned over the effect of the STET on the economy and investment in general. Such tax could result in distortions in the market. While the Council does not keep statistics on the income level of investors in stock, bonds and other securities, others have indicated that many are held by middle income Americans, pension funds and other entities. It is not clear that imposition of such a tax would affect only the upper income taxpayer as some evidently believe.

## CONCLUSION

The National Council appreciates the opportunity to share our concerns with the Committee on Finance. We recognize the the task of finding the increased revenue mandated by the Budget Resolution is a difficult one. We ask, however, that the Committee give full consideration to the impact of proposals suggested in the "Description of Possible Options to Increase Revenue" upon thrift institutions and the economy in which thrifts operate.

Statement of

Frank Hodsoll

Chairman,
National Endowment for the Arts

Chairman,
National Council on the Arts

On behalf of the National Endowment for the Arts, I am grateful for the opportunity to present the Endowment's views on some of the possible options to increase revenues prepared in June by the staff of the Joint Committee on Taxation in conjunction with the staff of the House Committee on Ways and Means. I should note at the outset that this testimony reflects only the views of the Endowment.

The National Endowment for the Arts was established (P.L. 89-209) in 1965 as the Federal agency to encourage and support "national progress in the arts". The Endowment provides grants and leadership in support of artistic excellence and access to, and appreciation of, the arts. Endowment grants to institutions qualifying as tax exempt under Section 501 (c) (3) of the Tax Code (83 percent of the value of all grants in FY 86) must generally be matched with non-Federal funds at least one to one, and one of the goals of the Endowment is to stimulate increased non-Federal contributions to arts organizations so as to enhance their financial stability.

Based on 21 years of working with the nation's non-profit arts community, we wish to comment on the potential effects on that community, and philanthropy generally, of some of the options before the Committee for increasing Federal revenues. We hope that our perspective will be useful to Members of the Committee as they consider the various revenue raising options before them.

We understand the Ways and Means Committee's wish to consider revenue options in connection with the FY 1988 House Budget Resolution and in that connection to consider reductions in individual and corporate tax preferences. We have no comment on most of the staff-prepared options, but we are very concerned about those that affect the philanthropic sector of which the arts are a part.

In summary, we oppose:

A. The staff prepared option to impose a five percent excise tax on net investment income of tax-exempt organizations (even if sunsetted once the budget deficit has been reduced to a specified level), because we believe it would undermine decades of hard work by arts organizations (and other tax-exempt institutions) to achieve financial stability through the creation of endowments and the like. Such an excise tax would also undermine the efforts of the Endowment's expenditure since FY 1982 of $65.4 million in Congressionally appropriated Challenge funds explicity to build endowments and cash reserves in arts organizations.

B. The staff prepared options which would limit charitable deductions for taxpayers who itemize: (1) limiting itemized deductions to the lowest (15 percent) tax rate, and (2) placing a floor of 10 percent of a taxpayer's adjusted gross income in excess of $50,000 ($100,000 for a joint return) under the total amount of that taxpayer's itemized deductions. We believe that these options would have a significant adverse impact on charitable giving which as a matter of public policy is particularly to be encouraged in a time of Federal budget constraints.

Attached to this testimony is a resolution of the National Council on the Arts in support of these positions, unanimously adopted at the Council's meeting on August 1, 1987. (One of the members of the Council is former Secretary of Treasury C. Douglas Dillon.)

We also join the Chairman and Ranking Minority Member of the Subcommittee on Oversight of the House Ways and Means Committee and Deputy Assistant Secretary of the Treasury Chapoton in emphasizing the need for additional information before specific proposals involving business income of tax exempt organizations can be put forward. We specifically include in this last respect consideration of limiting consolidated return pass-throughs and partnership allocations (at least insofar as these provisions apply to subsidiaries of tax exempt organizations) and limitations on equity kickers on loans by tax exempt organizations to business ventures. We agree that thoughtful recommendations in the unrelated business income tax (UBIT) area should not be driven solely by revenue considerations.

## Nature of Tax-Exempt Sector in the Arts

Tax exemption for public charities is based on the belief that their activities are in the public interest and not adequately supplied by market forces alone. Voluntary private efforts on behalf of society have characterized the American experience from the earliest days -- in religion, education, health, culture and social welfare. The Revenue Acts of 1913 and 1917 recognized the desirability of these activities which predated the Revenue Acts, and so exempted them from income tax and provided for deductions from taxable income of contributions to them.

While it is true that these provisions, which have in general been continued to the present day, can be characterized as tax expenditures subject to curtailment (as with any other Federal spending) in order to enhance revenues in a time of Federal budget deficits, it is also true that these provisions represent Congressional recognition that economic activities in the public interest, without net economic benefit to those supporting them, reduce the need for direct government intervention. Voluntary citizen efforts on the people's behalf, without profit to any one of them, can be encouraged through the Federal tax system. In this sense, tax incentives for charitable contributions are different than other tax incentives; the taxpayer who uses them always suffers a net loss in disposable income (but presumably receives non-tangible benefits in return, as such contributions benefit society as a whole).

Support of the arts in our system is generally a part of support of education. The arts that make a profit are generally created, produced, presented and distributed by the "entertainment industry" which is "for-profit" and pays taxes in the normal way. But the "for-profit" arts rarely include our cultural heritage and the majority of contemporary expression. They rarely include Shakespeare, Whitman, Beethoven, Copland, George Balanchine and Martha Graham. And, they rarely include the formerly commercial: Cole Porter and Jerome Kern, D.W. Griffiths and much of John Huston. Nor do they generally include the fine institutions which study, preserve and exhibit the art of all ages -- our nation's museums -- or publish much of today's poetry or present the great variety of music, drama, opera, theater, and dance, which lies outside the popular culture of the moment.

It is the activities of these institutions for which tax exemption in the arts is accorded. It is the needs of these institutions and artists, and making what they do accessible to the American people, that caused the 89th Congress to enact the National Foundation on the Arts and the Humanities Act of 1965 to provide for a direct governmental supplement to the private support that has not been taxable from the beginning of the Federal income tax. The Act specifies that "encouragement and support of national progress in the humanities and the arts, while primarily a matter for private and local initiative, is also an appropriate matter of concern to the Federal Government."

The last 20 years have been years of enormous growth in the not-for-profit arts. Twenty years ago there were only 37 dance companies, primarily located in New York City; today there are 240 throughout the country. Less than two dozen professional not-for-profit theaters have multiplied to more than 400, in every state of the union. There were in 1979 (the most recent survey) over 600 art museums and over 300 museums with substantial art collections, and a more recent survey shows that one third of a national sample of art museums have been founded since 1960. Twenty-seven opera companies have multiplied to nearly a hundred opera companies, and the number of symphonies has tripled from 58 to 165, in the same time period. The number of American artists has also grown enormously -- from 736,960 in 1970 to 1,482,000 in 1985.

This growth in the availability of the arts has meant that many more Americans throughout the country are now able to participate in their cultural heritage and the greater part of contemporary expression which lies outside the popular culture of the moment. Sixty-four million Americans did so in 1982, and 63 percent of adult Americans would like to attend more often. Nearly 15 million people attended non-profit professional theater performances in 1986 as compared with one million in 1965; attendance at orchestral concerts rose from 10.5 million to 22.7 million in the same period. Over six million people attended opera performances during the 1984-85 season as compared with four million during the 1969-70 season. The audience for dance has increased from one million in 1965 to 16 million today. Large museums in major cities are estimated to attract between 500,000 and 2 million visitors each year.

This enormous growth in arts activities and audiences could not have happened without citizen support. While non-profit arts institutions earn substantial amounts through ticket sales, museum memberships and the like (over 50 percent on average), the price of those tickets and memberships accounts for less than half of the actual cost of attendance, and most arts institutions provide free activities to reach out to audiences that could not afford even the price of a subsidized ticket or membership.

Where does the subsidy come from? It comes principally from private individuals and to a lesser extent from corporations, foundations and government (Federal, state and local). The recent growth in arts activities, which has brought art beyond the popular culture to millions, has been fuelled primarily by extraordinary growth in private contributions -- from $559 million in 1967 to $5.8 billion in 1986. From 1980 to 1986 alone, private contributions have increased from roughly $3 billion to $5.8 billion (nearly doubling in six years).

It is important to note that during the 1980-86 period Federal appropriations for the arts have remained relatively flat in nominal terms (down in real terms), as a contribution to reducing the Federal budget deficit. On the other hand, state appropriations for the arts have over doubled -- from $101.028 million in 1980 to $218.805 million in 1987 -- reflecting the view of state legislatures and governors in the great majority of states that arts funding is very much in the public interest. But the fact remains, and should remain, that private support on a tax deductible basis is the cornerstone of non-profit arts support -- well over 90 percent of total support. The diversity of this private support encourages diversity in the arts and preserves freedom of choice for the citizenry.

## Possible Options Prepared by Staff of Joint Committee on Taxation with Staff of Committee on Ways & Means

The Arts Endowment is particularly concerned about the staff prepared options (A) to impose an excise tax on net investment income of tax exempt organizations; and (B) to delete charitable deductions for taxpayers who itemize: either (1) limiting itemized deductions to the lowest (15 percent) rate, or (2) placing a floor of 10% of the taxpayers adjusted gross income in excess of $50,000 ($100,000 if a joint return) under the total amount of that taxpayer's itemized deductions. We believe these provisions could have a serious adverse impact on the stability of non-profit arts organizations and on charitable contributions generally.

### A. Excise Tax on Net Investment Income of Tax Exempt Organizations.

The staff prepared option to impose a 5% excise tax on net investment income of all tax exempt organizations would undermine decades of hard work by arts organizations (and other tax exempt institutions) to achieve financial stability through the creation of endowments and the like. Tax exempt organizations in general, and arts organizations in particular, have to raise each year enormous sums to maintain their operations and serve the public interest. The development of endowments and investment income provides a measure of financial stability and cushion from the vagaries of annual contributions. These efforts allow such organizations to ride out a bad year.

In the arts, these considerations are particularly important. It is generally conceded that arts institutions are undercapitalized, generally lacking the endowments that are normal in institutions of higher education.

To help alleviate this lack of capital base of arts institutions, the National Endowment for the Arts changed its Challenge Program in 1983 specifically to stimulate the establishment and enhancement of arts institution endowments and cash reserves. With the support of the Endowment's Appropriations Committees and the Congress, the Endowment has obligated $65.4 million to create and enlarge such endowments and cash reserves. This federally directed stimulus has catalyzed nearly $200 million in new private endowment and cash reserve funds. It is unlikely that the private donors of these funds would have been as willing to provide endowment and cash reserve gifts (normally harder to raise than project and building support) had there been an excise tax of 5% placed on the income therefrom.

The staff prepared option states that in time of large Federal budget deficits all organizations benefiting from Federal expenditures should be called upon to contribute to reducing the budget deficit. This may be true in the for-profit sector, but not-for-profit organizations undertake tasks in the public interest (for which tax exemption existed from the beginning of the Federal income tax); their existence, activities and help provide an alternative to, and reduce the need for, government intervention -- thus reducing the pressure on the Federal budget. They should not be penalized for seeking financial stability in doing this.

While it may be true that an excise tax on investment income would have a limited impact on the totality of exempt organizations, we believe it would adversely impact just the source of income which most provides for long term stability and therefore long term capacity to carry out activities in the public interest. Those activities that are most in the public interest surely involve long term engagement on society's behalf; this is as true for arts institutions as education institutions; it is in the national interest that their long term stability be enhanced with minimal direct federal appropriations.

Finally, no one is arguing that tax exemption of net investment income to tax exempt organizations creates unfair competition with the for-profit sector. We completely agree with Deputy Assistant Secretary of Treasury Chapton that "an exempt organization's investment of capital in a taxable business should not generally raise concerns over unfair competition". We also agree with him that "exemption for passive investment income may appropriately encourage exempt organizations to avoid deeper commercial involvements and the potential distractions and conflicts they present".

## B. Limitation on Charitable Deductions for Taxpayers Who Itemize

### 1. Limitation of Itemized Deductions to the Lowest (15% Percent) Tax Rate

Limiting the highest rate of deduction to the lowest (15 percent) tax rate, when under current law the highest tax rate is 38.5 percent, would significantly reduce current incentives for charitable contributions and would likely have an important adverse effect on philanthropy itself.

The argument that this option would eliminate the greater proportionate benefits that higher income taxpayers receive under present law ignores the fact that these higher income taxpayers are paying taxes at higher rates than lower income taxpayers to begin with, and that therefore deductibility at the higher rate is equitable since the tax exempt purposes of charitable deductions are in the public interest. The higher income taxpayer should be, and is, taxed at a higher rate to provide revenues for direct government expenditures in the public interest; such a taxpayer should not be taxed on income which he or she contributes directly to support activities in the public interest, particularly when, even at this year's highest rate, 61.5 percent of the contribution represents his or her own resources.

The option also has the effect of applying a limitation on deductions for state and local taxes and mortgage interest. One of the great debates prior to passage of the Tax Reform Act of 1986 (TRA) involved the question of deductibility of state and local taxes; that debate was resolved in favor of continuing their deductibility, and the issue would not usefully be reopened within one year. Most would also agree that the traditional interest in encouraging home ownership militates against a limitation on deductibility of mortgage interest.

Further, since state and local tax payments are not optional expenditures and home ownership normally requires payment of mortgage interest, the only truly discretionary expenditure affected by this option involves charitable giving. At a time when federal budget constraints argue for greater private activity in the public interest, it makes no sense to establish additional burdens to charitable giving. We agree with the Joint Committee staff that the proposal would also add further complexity or tax complications for tax itemizers.

2. A Floor of 10 Percent of A Taxpayers Adjusted Gross Income in Excess of $50,000 ($100,000 for A Joint Return) Under the Total Amount of That Taxpayer's Itemized Deductions

The 10 percent floor option similarly would reduce the incentive for charitable giving by those who can afford to be generous. The argument that personal consumption should not be subsidized through the tax system does not apply to charitable deductions which subsidize activities in the public interest, not consumption. As in the case of the option to limit the rate for charitable deductions, this option's potential impact on state and local tax deductions and home mortgage deductions goes contrary to the resolution of the Congress in enacting the TRA.

Existing tax law reflects appropriate tax policy regarding floors to deductions, in that different floors are placed on different deductions: 7.5 percent for medical expense; 10 percent for casualty and theft losses greater than $100; 2 percent for miscellaneous itemized deductions. It is current tax policy that there should be no limit on state and local income and real property tax deductions as a matter of comity with state and local governments, that policies in favor of home ownership militate against restricting mortgage deductions, and that general deductibility of charitable gifts (from 1913 and 1917 on) should not be restricted (except as a cap).

## Growth of Tax Exempt Sector and Problems

Although tax exemption and deductibility for charitable and other societally desirable activities have been a part of our tax laws since 1913 and 1917, it is also true, as Deputy Assistant Secretary of Treasury Chapton has noted, that growth in the exempt sector has both increased the importance of tax exemption and deductibility and has tended to blur the historical differences in activities and funding between exempt and taxable organizations. There is no question that there have been abuses, and in 1950 Congress enacted the Unrelated Business Income Tax (UBIT), largely in response to concerns about unfair competition between exempt organizations and taxable businesses. The application of UBIT was expanded in 1969, and in 1984 the Congress provided that tax exempt organizations would no longer be entitled to the investment tax credit and accelerated depreciation.

Under current law, tax exempt organizations can earn a profit but not distribute it to their owners or members; they can also earn income (without taxability) that is related to their tax exempt purpose. For example, performing arts institutions can without tax on the revenues sell tickets to an audience, and museums can similarly sell reproductions of the works of art in their collections. In addition, tax exempt organizations benefit from the availability of federally subsidized mail rates, numerous state and local tax exemptions, and exemption and special treatment under other federal and state requirements (e.g., social security, unemployment, and minimum wage provisions). But these tax exempt organizations which are public charities all have to raise money from contributions to make up the losses they sustain in achieving public purposes.

The Office of Advocacy of the Small Business Administration believes there has been an increase in commercial activities engaged in by tax exempt institutions, particularly by hospitals and higher education institutions (which together account for almost 70% of the non profit sector). The General Accounting Office (GAO) in its February 1987 report in response to a request of the Joint Committee on Taxation states that "representatives of the taxable business community question the appropriateness of tax exempt organizations competing with taxable businesses and question the justification for tax exempt status in these situations".

On the other hand, the GAO report notes that the tax exempt community, while recognizing that some tax exempt organizations are expanding their income producing or commercial activities, believes this expansion is important to furthering tax exempt purposes. The tax exempt community also believes that some competition has always existed as between the tax exempt and for-profit sectors and that the increase in this competition is largely due to taxable businesses expanding their activities into areas traditionally regarded as tax exempt (e.g., day care and physical fitness activities). Representatives of the tax exempt community have also pointed out that the for-profit small business community has a number of advantages not available to the tax exempt community: e.g., government contracts designated solely for small businesses (set-asides), tax credits, loan guarantees, and access to capital through stock issuance.

While the Endowment cannot comment on problems stated to involve unfair competition between tax exempt and for-profit organizations in non-profit sectors other than the Arts, we do believe the American Arts Alliance's survey of arts institutions reporting unrelated business income shows that arts organizations are likely complying with current law and regulations. In their testimony of June 5, 1987, the Alliance noted that most respondents have never been audited by the Internal Revenue Service regarding unrelated business income. Of the 35 institutions that reported such audits, 25 were found by the IRS to be in compliance with the law, and nine were awaiting a final ruling. The Survey indicated that only one institution responded that the final audit was unfavorable.

There is no question that there are major issues posed by the intersection of the tax exempt and for-profit sectors. The issues are not new; they have been present since enactment of a general income tax; and, as noted, new provisions have been added to the tax laws to deal with these issues. What is not clear is whether the current situation requires additional legislation or whether current law, perhaps with additional enforcement, is adequate to deal with the issues.

Essentially all parties at interest appear to agree that there is a need for better information, research and analysis in this area. This is as true of the Office of Advocacy of the Small Business Administration as it is of the non profit sector. And, both the Chairman and Ranking Minority Member of the Subcommittee on Oversight of the House Committee on Ways & Means agree that there is only limited data available and that additional data and information are needed to measure the nature and magnitude of the competition between taxable and tax exempt organizations. The Subcommittee on Oversight and the Treasury Department believe such information must be developed before specific proposals regarding UBIT can be put forward.

The Arts Endowment agrees with this conclusion. The GAO February 1987 report did not verify whether the unfair competition cited by representatives of the taxable business community actually existed; nor could the GAO determine whether tax exempt organizations offered goods and services for more or less than taxable businesses nor whether tax exempt organizations realized a surplus from their competitive activity. We believe that such evidence must be in hand across-the-board before across-the-board legislation should be enacted to tighten current tax laws regarding the tax exempt sector.

The staff prepared option to limit consolidated return pass-throughs makes a great deal of sense in principle, and Deputy Assistant Secretary of Treasury Chapoton has suggested changes in the definition of controlled organizations and in the ownership attribution rules as they relate to controlled subsidiaries of non-profit organizations. We, nonetheless, believe that consideration of this matter in the tax exempt sector should be part of an overall anaylsis of the issues. There are also, as the staff paper notes, administrative difficulties with such limitations.

Similarly, we believe the staff prepared options on partnership allocations and equity kickers on loans to business ventures should await further study. While we agree that partnership allocations that are actually sales of tax benefits can cause economically inefficient investment decisions and can be unfair, we also note that there are a number of limitations already in place to control this situation. We believe tax exempt entities should not be held to stricter standards of distinguishing debt from equity than other investors. Deputy Assistant Secretary of Treasury Chapoton has noted the difficulty of structuring partnership restrictions (e.g., regarding debt financed property rules). Again, we believe consideration of this matter should be part of overall analysis of the issues involving non-profits engaged in business ventures.

The unrelated business income of tax exempt organizations should be taxed, and it is taxed now. The only question involves what is "related" or "unrelated"; this is now determined from the facts of individual cases in relation to the tax exempt purposes of the organizations involved. As in any system of case by case determinations, the administrative and judicial process produces inconsistencies of interpretation; but so can enactment of new legislation; and the question remains whether there is an across-the-board problem that can be equitably resolved by across-the-board solutions. Thus, we would urge development of a better information base on the basis of which the various parties at interest can rationally argue the merits of their respective positions.

In conclusion, the Endowment believes that the compromises contained in the Tax Reform Act of 1986 regarding individual deductions should not at this time be significantly altered. Given the basic balance of interests achieved in that Act, the country would be better off if the TRA were left largely alone until the results of those balances can be measured. This is particularly so with regard to charitable deductions. The reduction in marginal rates, the elimination of charitable contribution deductibility for non-itemizers, and the inclusion of gifts of appreciated property in the minimum tax base all impact the tax exempt sector. While the results of those changes cannot yet be estimated, the Endowment urges that analysis of those results be undertaken before new burdens are placed on the not-for-profit sector. We also believe that the staff prepared options to limit deductibility are counter to long standing tax policy.

With regard to the issues involving the intersection of the tax exempt and for profit sectors, the Endowment concurs with the Chairman and Ranking Minority Member of the Subcommittee on Oversight of the Ways and Means Committee that revenue options with regard to UBIT should not be considered until better information and analysis is available. The Endowment is prepared to cooperate in developing such information and anaylsis with respect to not-for-profit arts organizations.

Finally, we believe that consideration of revenue raising options that impact the tax exempt sector should carefully weigh the public purposes that this sector achieves in the public interest. In a time of Federal budget deficits, it is of great importance that we do not through tax revenue options increase the pressures for larger Federal appropriations.

Tax incentives for charitable contributions encourage some portion of the taxpayers' disposable income to be spent to advance the public interest. Such tax incentives are cost beneficial to the Federal Government in comparison to direct appropriations. They also permit decision-making with regard to the public interest to be made at the local level. As the National Endowment for the Arts and the Humanities Act stipulates, this is the primary consideration in support of the arts. As in education, governance of our nation's artistic effort has been, and should remain, in the hands of the people.

## NATIONAL COUNCIL ON THE ARTS RESOLUTION ON PROPOSED TAX CODE CHANGES

(adopted unanimously August 1, 1987)

WHEREAS, in 1965, the National Endowment for the Arts was established as the Federal agency to encourage and support national progress in the arts and to provide a catalyst for increased support of the arts;

WHEREAS, it is a goal of the Endowment to promote the overall financial stability of America's best arts organizations through stimulation of increased non-Federal contributions to them;

WHEREAS, Federal funding for the arts, while an important and necessary aspect of support for the arts, plays a secondary role to support from private sources, and therefore the Declaration of Purpose of the National Foundation on the Arts and the Humanities Act (as amended) creating the Endowment stipulates that: "the encouragement and support of national progress and scholarship in the humanities and the arts, while primarily a matter for private and local initiative, is also an appropriate matter of concern to the Federal Government;"

WHEREAS, certain options to increase revenues are under consideration by the staff of the Joint Committee on Taxation and the staff of the Committee on Ways and Means, including a proposed excise tax on the net investment income of exempt organizations and proposed changes in the charitable deduction for taxpayers who itemize;

WHEREAS, an excise tax of 5% on net investment income, including interest and dividends, of organizations that are exempt from Federal income tax would have severe negative impact on the financial stability of many of the nation's finest arts institutions;

WHEREAS, (i) making charitable deductions for itemizers deductible only at the 15 percent tax rate notwithstanding the marginal rate of the taxpayer (under current law, the highest rate is 38.5%); (ii) placing a floor under aggregate itemized deductions (including charitable deductions) for higher income taxpayers; and (iii) reducing individual and corporate tax preferences would significantly reduce the incentives for philanthropy and philanthropy itself;

WHEREAS, enactment of these proposed tax law changes would further complicate the tax structure recently enacted in the Tax Reform Act of 1986 and have the effect of discouraging individual charitable donations at a time when non-profit arts organizations are increasingly in need of attracting private funding to meet their operating budgets;

WHEREAS, America's arts organizations are principally responsible for creating, producing, presenting, exhibiting, disseminating and conserving the quality and variety of art which is at the core of American civilization so that it might be made more available to the American people;

WHEREAS, many of our best arts organizations are severely undercapitalized, and therefore need to establish or build endowment funds to enhance their financial stability;

WHEREAS, in furtherance of this goal, and with Congressionally appropriated funds and based on the advice of this Council, the Endowment has since 1983 stimulated and assisted through expenditure of $51.5 million in Challenge funds the establishment and enhancement of endowments for these institutions;

WHEREAS, smaller, newer or less developed arts organizations face similar challenges, particularly those organizations which serve minority, rural, tribal, or inner-city populations;

WHEREAS, the Congress has reaffirmed since 1913 the importance of encouraging through tax incentives voluntary activity in the public interest and such activity reduces the need for increased direct Federal appropriations and increases freedom of choice among these activities;

NOW THEREFORE BE IT RESOLVED this 1st day of August 1987 that the National Council on the Arts opposes the proposed changes (cited above) affecting donations to and the income of non-profit arts organizations and urges that they be rejected, because they would significantly impede private support of the arts, and impose serious financial burdens on such arts organizations. These changes include a proposed excise tax on investment income of tax exempt organizations and proposed limitations on charitable deductions for non-itemizers.

NATIONAL COUNCIL ON THE ARTS

The above resolution was adopted unanimously by the National Council on the Arts, August 1, 1987.

Frank Hodsoll

Frank Hodsoll
Chairman

MEMBERS OF THE NATIONAL COUNCIL ON THE ARTS

David Baker
Composer/Teacher
Chair, Jazz Department
Indiana University
School of Music

Phyllis Berney
Collector/Patron
Former Member,
Wisconsin Arts Board

Sally Brayley Bliss
Lecturer/Dance Consultant
Former Dancer

Nina Brock
Patron/Trustee
Former Chair, Tennessee
Arts Commission

C. Douglas Dillon
Former Chair, Metropolitan
Museum of Art
Former Secretary of Treasury

Allen Drury
Novelist

Joseph Epstein
Writer/Teacher
Editor, The American Scholar

Helen Frankenthaler
Painter

Robert Garfias
Dean of Fine Arts
University of California, Irvine

Margaret Hillis
Director,
Chicago Symphony Chorus

Celeste Holm
Actress

Robert Johnson
Chairman,
Florida Arts Council
State Senator

M. Ray Kingston
Architect
Former Chair,
Utah Arts Council

Ardis Krainik
General Manager,
Lyric Opera of Chicago

Raymond Learsy
Art Collector
Trustee, Whitney Museum
of American Art

Harvey Lichtenstein
President & Executive Producer,
Brooklyn Academy of Music

Samuel Lipman
Music Critic
Publisher, The New Criterion

Talbot MacCarthy
Former Chairman,
Missouri Arts Council
Chairman, Voluntary Action
Center of Greater St. Louis

Arthur Mitchell
Executive/Artistic Director
Dance Theater of Harlem

Carlos Moseley
Pianist/Trustee
Former Chair,
New York Philharmonic

Jacob Neusner
Professor of Religious Studies
Brown University

Lloyd Richards
Dean, Yale School of Drama
Artistic Director,
Yale Repertory Theater

George Schaefer
Producer/Director
Plays, Film, Television

Robert Stack
Actor

William Van Alen
Architect/Trustee

James Wood
Director,
Art Institute of Chicago

# WRITTEN STATEMENT OF THE NATIONAL GRANGE
# SUBMITTED TO THE SENATE FINANCE COMMITTEE
# UNITED STATES SENATE
# JULY 22, 1987

RE: OPTIONS TO RAISE REVENUE IN ORDER TO MEET RECONCILIATION INSTRUCTIONS

Mr. Chairman, on behalf of the over 365,000 members of the National Grange, we appreciate the opportunity to submit for the record the Grange's view on a number of tax increase proposals. The statement will not be in order of importance to the Grange but for ease of reading, it will follow the sequence established in the Joint Committee print entitled "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means", published June 25, 1987.

It is the Grange's understanding that H. Con. Res. 93 requires the Finance Committee to report legislation which raises revenues by $19.3 billion in Fiscal Year (FY) 1988, $22.0 billion in FY89, and $23.0 billion in FY90, a total of $64.3 billion over the next three fiscal years. This increased revenue will assist in deficit reduction, an area of great concern to the members of the National Grange. We do, however, have some major concerns with a number of the options and we do support others. In the remainder of this statement, those areas will be highlighted.

## EXCISE TAXES

### Alcohol Fuels

The National Grange supports the proposal to remove the 6 cents per gallon exemption for alcohol fuels. Those funds should not be used in the federal budget, they are dedicated funds to the Highway Trust Fund. We are strong supporters of the Highway Trust Fund and believe that this exemption benefits some highway users at the expense of others. It is true that the creation of alternate energy sources is important, however, there are ways to promote the production of gasohol blends that will not adversely affect the funds available for highway and bridge construction and repair. The Food Security Act of 1985 provided for such subsidization. The '85 Farm Bill allowed the Secretary of Agriculture to give free bushels of corn with purchased bushels. This helps to reduce the massive corn surplus and is a more equitable subsidy for the production of ethanol.

### Windfall Profits Tax

The Grange strongly supports the efforts to repeal the windfall profits tax. Currently, the U. S. Government is not collecting any revenue under the windfall profits tax. Yet millions of dollars must be spent annually by oil companies in order to collect the data that is needed to fill out the tax forms that substantiate the fact that they owe little, if any, taxes. It is projected that the repeal of the tax would have no revenue impact.

Even if oil prices rose from current levels, the windfall profits tax would be counterproductive to substantially increasing government tax revenues because as an excise tax on oil production that is designed to take as much as 70 cents of each dollar of additional oil industry revenue, the tax would substantially discourage the necessary investment in oil exploration and development that creates the revenues to pay the windfall profits tax. With the United States' dependence upon foreign sources of oil increasing and the U. S. oil industry facing economic dislocations due to lower worldwide oil prices, we consider it unwise to maintain government programs, such as the windfall profits tax, that artificially discourage the exploration for and production of U. S. domestic petroleum resources.

The fate of rural America is intertwined with the fate of our natural resources, such as oil. Energy costs are a large part of both the costs of production on our farms and the cost of living in rural areas. Energy exploration and development is a major employer in rural areas, just as those same areas bear a disproportionate burden of the economic and environmental risks of such development. The National Grange believes that national energy policy should not unduly interfere with the free market forces that best regulate the domestic demand for petroleum or the domestic oil industry's ability to meet that demand in an environmentally sound manner. The windfall profits tax is such an interference.

## Alcoholic Beverages

The National Grange supports the increase in excise taxes for alcoholic beverages. We believe that the tax should be based on the alcoholic content in the product. Alcoholic products are generally substitutes for one another, therefore, the tax should be based on the equivalent value of alcohol contained.

## Tobacco

The Grange strongly opposes an increase in the excise tax on tobacco products. As recently as April 7, 1986, Congress permanently doubled the federal cigarette excise tax from 8 cents to 16 cents per pack. Doubling the tax to 32 cents will cause the loss of 28,500 American jobs in the core tobacco industry. (In 1982, when Congress temporarily increased the tax to 16 cents, 14,600 American job opportunities in the industry were lost.) Moreover, doubling the excise tax will cause harm to the American tobacco farmer, their families, and communities. A 16 cent increase would result in an approximate decrease of $110 million in sales of leaf tobacco (27.4 million pounds), a result which will directly hit the farmer.

Tobacco is paying its fair share of taxes. In addition to the federal government, all 50 states and 388 city and municipal governments impose an excise tax on tobacco products. The average total tax on a pack of cigarettes is 37 cents (16 cents federal, 22 cents state and local). In addition to federal and state income taxes, over nine billion dollars were paid in excise taxes last year.

An increase in the excise tax on tobacco would be one of the most regressive of all tax increases considered. According to the Congressional Budget Office, as a percent of income, the increase would be more than 12 times higher for low income (under $5,000) families than for high income (over $50,000) families.

## Telephone and Luxury Items

Excise taxes in general are regressive in nature. With this in mind, we believe that an increase in telephone excise tax is poor public policy but an increase in the tax on luxury items (i.e., jewelry and furs) has merit. In the case of the telephone tax, low income families would pay more than 12 times as much as higher income families for a necessity. On the other hand, low income families normally do not buy luxury items, therefore, the regressive nature of the tax is reduced.

## Oil Import Fee and Gasoline Tax

The National Grange strongly opposes the imposition of an oil import fee. Additionally, we oppose an increase in the gasoline tax for any purpose other than to increase funds available in the Highway Trust Fund (at the present level of funding for highway programs, an increase is unnecessary at this time). Petroleum products are among the largest components of agricultural costs of production, both directly and indirectly. As petroleum prices escalated in the 1970's, farmers bore increased production costs. Now that petroleum is being priced in a more competitive market, farmers have the opportunity to narrow their cost-price squeeze.

The Food Security Act of 1985 sent a clear message to farmers that lower commodity support prices and gradual decreases in target prices over the life of the Act means that U. S. farmers must eventually adjust their operations to efficiently derive more of their income from market sources. Implicit in that message, we believe, is a commitment by the federal government to our family farmers that if their farm products must be sold in a competitive free market, then the inputs they use to produce those products must also be priced by a competitive free market. Oil import fees and gas tax increases distort petroleum product prices upward even further and break the government's commitment to this nation's family farmers. On a 300 acre farm, a $10-a-barrel oil import fee would raise the cost of production for wheat by $690, for corn by $1,080, for rice by $3,000, for soybeans by $660, and for cotton by $2,160.

As an essential commodity, gasoline is already heavily taxed. Based upon national averages, the total revenues to all levels of government from a 98.7 cents a gallon price for gasoline range from 27 cents to 37 cents. In addition to a 9 cents a gallon federal excise tax, the federal government also benefits from corporate income and corporate payroll taxes that are indirectly included in the price of each gallon of gasoline. Moreover, as gasoline prices decline, the taxes become a larger portion of consumer costs. Gasoline taxes have already risen 56 percent in this decade, and the federal tax jumped 125 percent in 1983.

In addition to farmers, residents of rural areas, especially those of the West, would bear a disproportionate share of the burden of a gasoline tax increase, and through that, a disproportionate share in reducing the federal deficit. Low income consumers would shoulder 48 percent more of the burden than middle and upper income families because the 1983 National Personal Transportation Survey by the U. S. Census Bureau indicates that nearly 78 percent of Americans who are earning less than $10,000 per year commute to work in private vehicles.

In non-urban areas, each household generates over 56 miles of auto travel daily as compared to about 40 miles of daily auto travel in large metropolitan areas with mass transit systems. Rural America will shoulder a 40 percent greater burden under a gasoline tax increase compared to residents of large cities who enjoy subsidized mass transit.

Western residents who rely upon gasoline to a greater extent than the national average will suffer under a gasoline tax increase. The per capita consumption of gasoline in Idaho is 467 gallons a year while New York's consumption is only 349 gallons. For Texas and Pennsylvania, the consumption is 581 gallons to 397. Higher per capita consumption means a higher burden under a gasoline tax. An increase in the motorfuel tax would force drivers in the South and West to contribute twice as much to deficit reduction as those in the North and East. For example, based on average annual consumption, drivers in the District of Columbia would pay $47.30 for a 10-cent tax increase compared to $127.20 in Wyoming.

An oil import fee would have much the same disasterous effect on farm and rural communities as does a gasoline tax increase. Some proponents of an import fee believe that many communities would benefit from the increased economic activity that greater oil and natural gas exploration would generate. Oil exploration, however, is greatly affected by criteria that are not driven by price, such as environmental laws, land use regulations, and multiple use values on public lands. A simple oil fee that leaves other barriers to exploration firmly in place would not result in substantially increased exploration, or increased economic benefit to rural America.

Furthermore, economists cannot agree on the degree of benefit, even to the U. S. Treasury, of an oil import fee. At best, an oil import fee would be a short-term infusion of funds to the Treasury. Over the long run, competitively priced petroleum products reduce input costs, help to control inflation, improve international competitiveness, increase real economic growth and decrease unemployment. These side effects produce more benefit for the U. S. Treasury and the entire U. S. economy than policies of targeted price manipulation, such as a gasoline tax increase or an oil import fee.

## Highway Trust Fund

The National Grange strongly opposes the movement of any funds from the Highway Trust Fund or an increase in the taxes which fund the Trust for the purpose of any use other than the Trust Fund. The Grange believes the Fund provides a "user-fee oriented" mechanism for the construction and repair of highways, rural roads and bridges. The quality of America's infrastructure is vital to the health of the agricultural economy.

## GENERAL CONSUMPTION TAXES

### Value Added Tax

The National Grange opposes any type of a value added tax (VAT). This type of national sales tax would be regressive in nature and would have a negative effect on agriculture. A VAT would increase the cost of production to agricultural producers and would further tighten their cost-price squeeze.

## INCOME TAX PROVISIONS

### Tax Rates/Brackets

The National Grange opposes any modification of the tax rates and/or brackets legislated in the Tax Reform Act of 1986 or a surtax on income tax liabilities. We have supported, and continue to support, a flat tax system. The result of the Act is the closest facsimile of a flat tax which is politically achievable at this time. Increasing the rates for certain brackets deviates from the flatest system achievable. Additionally, the lowered tax rates is the only reason that agriculture agreed to the loss of capital gains. If tax rates or brackets are modified, capital gains must be reinstated.

Moreover, an increase in tax rates will reduce savings, reduce employment opportunities and create other distortions due to the adverse effects on planned economic action. Further, an increase in rates or a surtax would break a pledge to taxpayers made by Congress when it passed the Act.

With respect to a temporary surtax, the Grange does not believe that this increase would be temporary but would be a permanent addition to the tax code, further distorting our desire for a flat tax.

For many of the same reasons stated above, the National Grange also opposes any changes in the rates made applicable to the Alternative Minimum Tax.

### Charitable Contributions

A number of the proposals in the Joint Committee print, if enacted, could result in a decrease of charitable contributions by as much as $6.7 billion. The Grange opposes any further loss in the deductibility for donations to charitable organizations. (We vigorously opposed the loss of charitable contribution deductions for non-itemizers in last year's debate.) We are also concerned about the possibility of an excise tax of 5 percent imposed on tax-exempt organizations. We encourage this Committee to consider these hidden results when enacting any of the revenue options.

### Non-Business Personal Property Deductions

The Grange opposes the disallowance of deductions for non-business personal property tax. In fact, the Grange opposed the loss of state sales tax deductions during the 1986 tax debate. The deduction disallowances would result in discrimination based on a taxpayer's residence. Residents in states which impose only real property or income taxes would benefit at the expense of residents of states who have chosen to impose a personal property tax.

### Cash Accounting

The Grange supports controlling the abuse of cash method accounting by large corporations. Two options may help to achieve that goal: 1) Placing a cap on the use of cash accounting at a level high enough to allow traditional family farmers to continue its use but low enough to restrict the use of cash accounting by large corporations; 2) eliminating the use of cash accounting if the taxpayer engages in related food processing activities.

## Passive Investment in Agriculture

The National Grange worked hard to reduce the possibility of passive investment in agriculture during the Tax Reform Act of 1986. We supported passage of that legislation due to strong language eliminating such investment. The Department of the Treasury has also developed regulations which will severely restrict passive investment. We encourage Congress to recognize that unlike rental activities, farming is a labor intensive and capital intensive business. In the past few years, many producing farmers have been required to take second jobs in order to survive on the farm during these depressed times. Treating rental activities and farming activities similarly does not recognize these differences.

## Depreciation of Single-Process Agricultural Structures

The National Grange supports lengthening the depreciation schedule to 15 years for single-purpose agriculture structures. During the '86 debate, House language called for 13 years, Senate language called for 10 years, and the Conference agreed to 7 years. We believe that 15 years is a more accurate reflection of the useful life of these structures. Any schedule less than 15 years simply encourages tax incentive production.

## Tax Exempt Status of Credit Unions

The Grange opposes the repeal of the tax exempt status of credit unions. For the most part, credit union membership is limited, they are more directly controlled by their members, and they are generally limited to consumer loans which are safer and pay a lower interest rate. The tax exempt status allows the credit union to act more cautiously and in the interest of their members.

## Oil and Gas Working Interest Provision

The Grange opposes the proposal to repeal the oil and gas working interest provisions. Volatility of the oil market and the high level of risk involved in oil exploration makes it difficult for drillers to acquire capital without the special tax treatment. The provision contained in the Tax Reform Act of 1986 encourages oil exploration which reduces America's dependency on foreign energy sources.

## VALUATION OF PROPERTY

### Estate Tax

The National Grange strongly opposes any changes in the current estate and gift tax laws, particularly as they relate to agriculture. The Grange was very active in estate tax reform in 1976 and again in 1981. Significant and necessary relief was provided in 1981 and many of the options before this Committee today would eliminate the achievements made over the last 11 years.

It must be recognized that taxes are not necessarily levied for the sole purpose of financing the government. Taxes can be a useful tool for implementing public policy and addressing public concerns. The Grange has worked in concert with other groups to establish as public policy the need to preserve and protect farmland for our future needs and to encourage family-sized farms and ranches to furnish food and fiber for domestic needs and international trade. The Grange is alarmed at the rate at which this country is losing its farmland and the decreasing number of families deriving their income from agriculture.

The concerns of our organizations for the future of family agriculture involve the issues of resource conservation and farm structure, and both can be addressed through estate and gift taxation. Estate and gift taxation must be placed in the broader context of agricultural and land use policy. Simply stated, estate and gift taxes significantly affect farm structure. Changes obtained to allow agriculture to continue to be a feasible vocation for the sons and daughters of those in the agricultural industry must be retained. By facilitating the means by which farm estates can be passed on intact to heirs who desire to remain on the farm, efficient-sized agricultural operations will be assured for the future. Much of the decrease in the number of farm families can be attributed to the changes in agricultural production methods and technological improvements within agriculture. There are, however, limits to economies of scale, and farms should not be encouraged to expand beyond these limits. The Grange believes estate taxes are based on a sound premise and should not be modified at this time.

## CONCLUSION

The National Grange realizes that the task ahead of the Finance Committee is very difficult. As mentioned above, we support efforts to reduce the size of the federal deficit, however, many of the above-referred to options will have a damaging effect on American agriculture and rural America. However, we encourage you to review the areas which we believe can assist in deficit reduction and would be acceptable tax and public policy.

## NATIONAL ALCOHOL TAX COALITION
## STATEMENT ON ALCOHOL EXCISE TAXES

The National Alcohol Tax Coalition is comprised of diverse national, state, and local groups that support a substantial increase in federal excise taxes on alcoholic beverages. Increased taxes will serve two purposes: they will help reduce the enormous cost of health and social problems related to alcohol abuse by discouraging excessive alcohol consumption and they will enrich the U.S. Treasury by billions of dollars. This extra revenue will lessen the deficit-driven need to further decimate vital domestic social programs. In addition, new revenues can help expand funding for alcohol abuse prevention, treatment, and research, as well as provide increased stability for public health care programs such as Medicare.

The economic costs of alcoholism and problems related to alcohol abuse are staggering. According to government-sponsored studies and reports, alcohol-related problems cost society approximately $120 billion and 100,000 - 200,000 deaths each year, plus untold amounts of human grief and suffering. The catastrophic damage linked to drinking includes:

- 53% of all traffic fatalities;
- as many as 60% of child and spouse abuse cases;
- industrial and recreation accidents;
- over 50% of violent crimes, suicides, fatal fires, and drownings;
- birth defects, spontaneous abortions, and liver damage;
- rising incidence of teenage drinking; and
- alcohol dependence for nearly 13 million Americans.

Until Congress recently authorized an increase in taxes on distilled spirits, federal alcohol excise taxes had not been raised in thirty-four years; the rates for beer and wine still remain at their 1951 levels. The failure to raise federal excise tax rates has resulted in a steady decrease in the tax rate and tax revenues in terms of real dollars. The failure to index federal excise taxes to inflation has resulted in a loss of billions of dollars of revenue. While Congress scrambles to find ways to lessen the burgeoning budget deficit, the possibility of additional alcohol tax hikes remains a viable — and increasingly inviting — political option.

**We urge the President and Congress to join the majority of Americans who recognize alcohol abuse as a major national problem and who support higher federal alcohol taxes on alcohol beverages as a means of improving our nation's social and economic health. As a start, we offer the following suggestions: restore the tax on hard liquor to its 1974 level, raise taxes on beer and wine so that these beverages are taxed at the same rate per unit of alcohol as liquor, and to prevent these taxes — and prices — from being eroded by inflation, adjust alcohol taxes annually for increased inflation and disposable income. Finally, a portion of these revenues should be allocated to help reduce alcohol problems and expand access to health care services. These measures might be implemented on an incremental basis to avoid sudden economic dislocation and consumer resentment.**

Increasing alcohol taxes alone will not independently solve America's alcohol problems or budget deficits, but we believe that this measure is one important step in that direction.

## NATIONAL ALCOHOL TAX COALITION
## NATIONAL SUPPORTERS

Adventist Health Network
Alcohol Policy Initiatives Project, Trauma Foundation
American Association of Retired Persons
American College of Preventive Medicine
American Council for Drug Education
American Council on Alcohol Problems, Inc.
American Licensed Practical Nurses Association
American Medical Students Association
American Nurses Association
American Youth Work Center
Association of Schools of Public Health
Center for Science in the Public Interest
Child Welfare League of America
Children's Defense Fund
The Children's Foundation
Christian Life Commission, Baptist General Convention of Texas
Citizens for Highway Safety
Consumer Affairs Committee of Americans for
    Democratic Action
Doctors Ought to Care

National Association for Public Health Policy - Council on Alcohol Policy
National Association of Children's Hospitals & Related Institutions
National Association of Junior Leagues
National Association of Private Psychiatric Hospitals
National Association of State Alcohol and Drug Abuse Directors
National Center for Drunk Driving Control
National Council on Alcoholism
Nationl Council on the Aging, Inc.
National Drivers Association for the Prevention of Traffic Accidents, Inc.
National Women's Christian Temperance Union
National Women's Health Network
Public Citizen
Remove Intoxicated Drivers

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*THE NEW YORK TIMES, WEDNESDAY, APRIL 30, 1986*

The New York Times

# Yes, Raise the Alcohol Tax

**A large group of leading economists proposes to raise $12 billion annually for the Federal Treasury by sharply increasing taxes on alcohol, which have not kept pace with inflation. Although sales taxes generally are not the best approach to budget balancing, reverting to higher taxes on alcohol seems a good way to help reduce the deficit.**

**Congress raised the excise tax on a fifth of 80-proof liquor last year from $1.67 to $2. But that increase, the first since 1951, still left the tax lower, in constant dollars, than it was at the repeal of Prohibition a half-century ago. The increase also widened the gap between taxes on hard liquor and those on beer and wine; beer is now taxed at one-fourth the liquor rate, wine at one-seventeenth.**

**The economists' group proposes doubling the tax on hard liquor to $4 a fifth, which would bring the tax rate, when adjusted for inflation, back only to the levels of 1972. Beer and wine would be taxed at the same rate as liquor, in proportion to alcohol content. That would add about $1.50 to the standard bottle of wine and six-pack of beer.**

**Such levels of taxation might discourage consumption of alcohol and raise less than the predicted $12 billion in revenue. But the Government and economy would presumably still benefit from gains in productivity and lower health-care costs, both of which are heavily affected by alcohol consumption. Increasing alcohol taxes is a sound way to either raise or save money.**

The Washington Post SATURDAY, SEPTEMBER 27, 1986

# *Higher Taxes on Beer and Wine*

THE WAR on illegal drugs that Congress and the administration are bent on prosecuting is going to be expensive. The bill already passed by the House carries a price tag of $3 billion. While the final legislation may be a bit more modest, proponents are calling for more law enforcement, more education programs, more treatment facilities and more aid to local governments. So far, no one in this era of Gramm-Rudman has said where the money is supposed to come from. There's not much chance the income tax is going to be increased, and the nondefense budget can't be trimmed much further.

There is one source of revenue, though, that hasn't been given sufficient attention. Appropriately, it is related to substance abuse. Any levy that will put almost $5 billion a year into the Treasury will make it easier to fund an ambitious new narcotics control effort. This could be accomplished simply by changing the formula for the federal excise tax on beer and wine.

A six-pack of beer now costs about the same as a six-pack of Coke. Alcohol in this form is cheap, which surely boosts the popularity of beer among teen-agers. The tax on wine is also low, and sales of wine coolers to young people are on the rise. But these taxes do not reflect the *alcohol content* of the drink. A can of beer, a glass of wine and a shot of liquor contain equal amounts of alcohol—a fact that many teen-agers don't recognize. Yet the federal taxes on each are, respectively, 2.7 cents, 0.5 cents and 10 cents. Why should there be such a disparity? The tax on distilled spirits has been raised in recent years—it went up only last October—while the tax on wine and beer has remained unchanged since 1951.

Thirty-six percent of adult Americans don't drink alcoholic beverages of any kind. Another third of this population has three or fewer drinks a week and for them an increase in the excise tax would hardly be noticed. Of the final third, some might drink less to compensate for the increased cost. If most chose to continue to consume beer and wine at the same rate in spite of higher taxes, the Treasury would be the beneficiary. Revenues would be substantial. Why aren't more people on the Hill talking about this idea seriously?

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Los Angeles Times Part II/Friday, March 27, 1987 ★

# Paying the Piper

It is time that Americans stop allowing themselves to be seduced by the notion they can have all the governmental goodies that they want without paying for them. While President Reagan denounced Congress all these years for being hooked on the idea of tax and spend, his Administration has engaged in a wholesale program of borrow and spend. As late as Wednesday he went to the Capitol and tried to apply his just-say-no drug message to taxes.

But time, and the horrendous federal debt, has rendered that message obsolete if not downright dangerous. After trillion-dollar defense increases and trillion-dollar tax reductions, the piper must be paid. A modest, even timid, down payment is the roughly $18-billion tax increase proposed by Democratic budget-makers in Congress.

Recent polls suggest that Americans are prepared to accept higher taxes to pay for expanded social programs. The Democrats' budget outline would not in fact prevent additional cuts in domestic spending. It would not even prevent the nation from going further into debt. But at least it would help brake the slide into an abyss of red ink.

The obvious place to start is with an overdue increase in excise taxes on alcoholic beverages, tobacco and gasoline. The $18.5 billion could be raised this way: doubling the cigarette tax from 16 cents a pack to 32 cents; doubling the federal gasoline tax from 9 cents to 18 cents; increasing the tax on distilled alcohol from $12.50 a gallon to $15 a gallon, and making the beer and wine tax comparable to that on distilled spirits.

None of these increases would work a severe hardship on the public. Each might have a beneficial social effect by modestly discouraging excessive smoking and drinking and encouraging gasoline conservation. They would produce no real drag on economic growth.

The beer and wine tax has not been raised since 1951. The tobacco tax is only about 15% of the market price of cigarettes, compared with 42% in 1951. As for gasoline, the U.S. tax levy on motor fuel is one of the lowest in the world, with many other countries charging as much as $1 a gallon. The special interests involved, particularly beer and wine and tobacco, have used their lobbying muscle to get a free ride for years. Excise taxes amount to less than 4% of the gross national product, compared with almost 9% in 1971.

An argument can be made that raising these taxes is good public policy even absent the budget deficit. Given the magnitude of the debt today, an increase is essential.

## ECONOMISTS' PETITION TO INCREASE FEDERAL ALCOHOL EXCISE TAXES

We, the undersigned economists, believe that the public health costs and other external costs associated with the consumption of alcoholic beverages are so significant as to justify substantial excise taxes on those beverages. In light of the fact that, in real terms, existing taxes have declined dramatically in the past thirty years and those on wine and beer were not increased even in nominal terms between 1951 and 1985, existing tax rates should be increased.

Further, we see no justification for the differential between the excise tax, per unit of alcoholic content, on beer and wine, on the one hand, and hard liquor on the other. Indeed, in light of the fact that beer is the standard introduction to alcohol for youth, favored tax treatment for it appears to be socially highly undesirable.

Finally, an increase in the excise tax on alcoholic beverages would contribute to the reduction in the budget deficit in a way that has no significant adverse economic effects and would have substantial social benefits, while tending to increase economic efficiency.

Consequently, we support efforts by the NATIONAL ALCOHOL TAX COALITION to increase federal excise taxes on alcoholic beverages and eliminate or modify the differential tax treatment between beer, wine, and liquor.

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** Nobel laureate

CSPI CENTER FOR SCIENCE IN THE PUBLIC INTEREST

## NATIONAL ALCOHOL TAX COALITION
## FACTS ABOUT FEDERAL ALCOHOL EXCISE TAXES

- Until a 19 percent increase in liquor taxes (not on beer and wine) effective October 1, 1985, federal excises on alcoholic beverages had not been increased since 1951.

- Beer and wine taxes are less than one-fourth of what they were at the repeal of prohibition; the tax on liquor is about 25 percent less (figures expressed in constant dollars).

- Due to inflation since 1951, the real dollar value of tax revenues on alcoholic beverages declined by 75 percent. Inflation during this period cost the Treasury between $40 and $75 billion in lost revenues.

- The current tax on a 12-ounce can of beer is 2.7 cents; on a glass of wine, about 0.5 cent; and on a shot of 80-proof liquor, 10 cents. The alcohol in liquor is taxed at about 4 times the rate of alcohol in beer, and about 17 times the alcohol in table wine.

- Government reports estimate the annual toll from alcohol abuse at between 100,000 and 200,000 deaths and $120 billion in economic damage.

- Higher alcohol taxes will reduce drinking by young people and heavy drinkers, and will reduce alcohol-abuser problems like fatal auto crashes and cirrhosis of the liver, according to economists at Duke University and the National Bureau of Economic Research.

- Doubling liquor taxes and then equalizing the rate of tax on alcohol in liquor, beer, and wine, as proposed by the Naitonal Alcohol Tax Coalition would:
    a) increase the tax on individual drinks of beer and wine by about 20 cents and on liquor, by about 10 cents; and
    b) provide approximately $12 billion in additional federal revenues, decrease alcohol consumption by about 14 percent, and reduce the annual economic costs of alcohol by up to $16 billion.

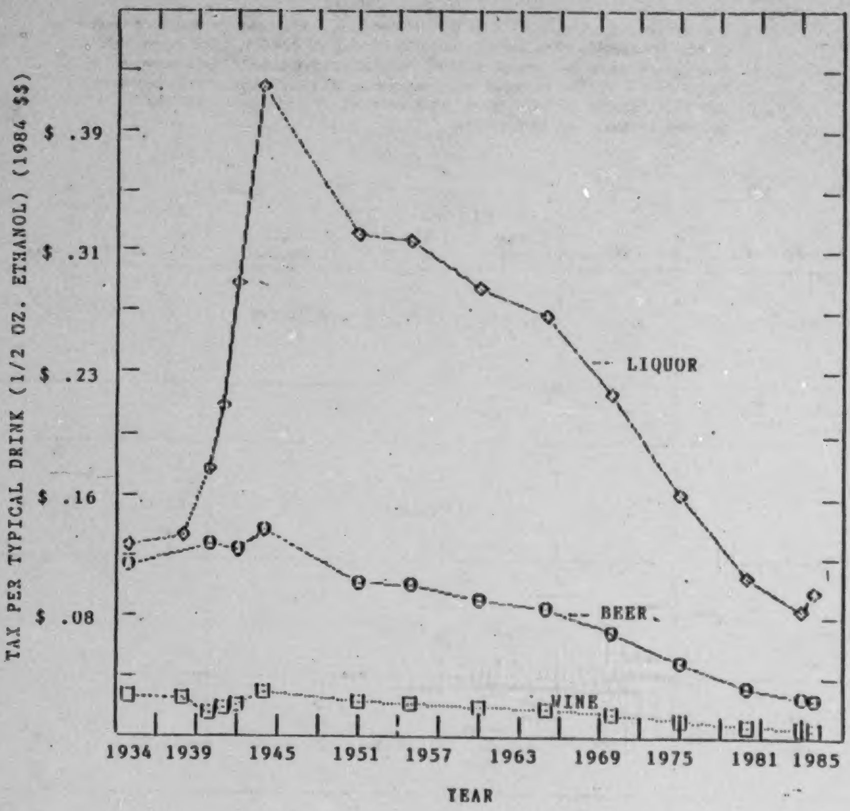
- The forty percent of American adults who do not drink would pay no additional taxes; ten percent of those Americans over 18 would pay over 60 percent of alcohol tax increases.

- The $12 billion in additional revenues is more than the total taxes paid by the 23 million taxpayers whose adjsuted gross incomes were under $12,000 in 1983.

- Twelve billion dollars would pay the combined annual costs of the Naitonal Institute on Alcohol Abuse and Alcoholism, the Administration on Aging, the juvenile justice and child abuse state grant programs, and the federal food stamp program.

- According to a George Gallup poll released December 18, 1986, 66 percent of the American public support doubling alcohol excise taxes.

RELATIVE TAXES ON BEER, WINE, LIQUOR (1934 - 1985)



## UPPER INCOME HOUSEHOLDS PAY THE BULK

## OF ALCOHOL EXICISE TAXES

For liquor and wine, over half the excise taxes are paid by the 38 percent of the households that have income in excess of $30,000. For beer, this same group pays just under half of federal excise taxes. Low-income households (<$10,000 income), who represent 20 percent of the population, pay 11.9 percent of beer taxes, 10.3 percent of wine taxes, and 10.7 percent of taxes on liquor.

| Household Income | $5000 | $5000–$9999 | $10,000–$19,999 | $20,000–$29,999 | $30,000 + | Total |
|---|---|---|---|---|---|---|
| Percentage of Households * | 7.66% | 12.43% | 22.40% | 19.08% | 38.3% | 99.87% |
| Percentage of Excise Taxes Paid: ** | | | | | | |
| Beer | 4.5% | 7.4% | 19.8% | 19.7% | 48.7% | 100.1% |
| Wine | 4.0% | 6.3% | 17.3% | 17.8% | 54.7% | 100.1% |
| Liquor | 4.0% | 6.7% | 18.0% | 18.7% | 52.6% | 100% |

Sources:

*U.S. Census Bureau (1985 population figures).

**"The Distributional Effects of an Increase in Selected Federal Excise Taxes," The Congressional Budget Office, January 1987, Table 3.

# STATEMENT

# OF THE

# NATIONAL BUSINESS AIRCRAFT ASSOCIATION, INC.,

Mr. Chairman and Members of the Committee:

Thank you for allowing the National Business Aircraft Association, Inc. (NBAA), to submit this statement. The NBAA represents the aviation interests of American business. Our 2900 member companies, operating some 5500 aircraft, depend on aviation to help them meet their daily business transportation needs. Any proposal which would result in increased taxes on business aircraft operators is of great concern to us and must be closely examined to determine its effect on the ability of American business to continue to use their aircraft in a reliable, safe and efficient manner. Unfortunately, the proposals before this Committee fail these tests.

Consequently, we must express our strong opposition to proposals found in the Description of Possible Options to Increase Revenues (the Options), prepared by the Joint Committee on Taxation and submitted to the House Committee on Ways and Means on June 25. That document describes the various options available to craft legislation increasing revenues by $19.3 billion in Fiscal Year 1988 and $64.3 billion through the three years ending with FY 1990.

The Options include proposals which, if enacted, would bring great harm to general and business aviation aircraft users, manufacturers and suppliers and which we must oppose. Specifically, we oppose those proposals which would:

1. Impose a ten percent "luxury" tax on general aviation aircraft;
2. Increase by five or ten cents per gallon the Federal excise tax imposed on aviation fuel as part of the Leaking Underground Storage Trust Fund (LUST) tax base;
3. Increase the current eight percent excise tax on transportation of persons by air to ten percent; and
4. Increase by 33 percent the excise taxes deposited into trust or special funds to offset "implicit contributions" to those funds and by an additional amount equivalent to the supposed revenue loss from revenue bonds used to finance related activities.

Allow us to discuss these tax proposals and their impact on business aviation in some detail.

## "LUXURY" TAXES ON GENERAL AVIATION AIRCRAFT

Perhaps the most onerous and ill-conceived proposal found in the Options is that which would impose a "luxury" tax on aircraft not used for the commercial transportation of passengers or cargo. This proposal suffers from several misconceptions, not the least of which is the mere hint of general aviation aircraft being "luxuries."

For the vast majority of general aviation operators, their aircraft are essential to their business activities, directly comparable in utility to computers, machine tools, warehouses and delivery trucks. They are used for the everyday transportation of employees, salespeople, customers and equipment to all locations around the world on schedules independent of the airlines. Far from being "toys" or "playthings", they are tools of commerce, maximizing business opportunities and enabling companies to travel to places at times otherwise impossible using commercial transportation. Imposition of a "luxury" tax on what has become a necessary capital investment for many businesses would be total repudiation of the uses to which these aircraft are put.

General aviation aircraft are also used for purposes other than business transportation. Examples include use as air ambulances, in energy exploration, agricultural application, aerial surveillance and search and rescue. The productive uses of general aviation aircraft, aside from their use in the transportation of persons or cargo for hire, strongly argues against their being considered "luxuries."

The Options also fail to recognize the contribution made to the nation's balance of trade and productivity through the use of general aviation aircraft. Only by maximizing the ability of American business to compete, both at home and abroad, will substantial progress be made in resolving the twin dilemmas of our national trade imbalance and budget deficit. Enactment of a "luxury" tax on general aviation aircraft, with concomitant impact on the flexibility and ability of American business to compete, would be detrimental to resolving the very problem from which it stems, namely the need to reduce the budget deficit.

Finally, a "luxury" tax on general aviation aircraft is ill-advised because of the damage which would be done to what remains of a once-vibrant manufacturing industry and its possibilities for the future. Once the world leader, the domestic general aviation manufacturing industry has fallen on hard times, with only 1495 new aircraft delivered in 1986, the fewest since World War II. In 1984, Cessna Aircraft, by all measures then the world leader, closed its piston-powered aircraft manufacturing facilities. Piper Aircraft now only makes one model continually, with others being made on an "as-needed" basis. Beechcraft, also a major manufacturer, makes only two piston-powered models. By contrast, various foreign manufacturers, including those from Canada, Brazil, France, Great Britain and Italy collectively threaten the long-standing preeminence of American companies in this field.

In light of the substantial and certain long-term damage which would be done to the industry and the simple fact that these aircraft are not "luxuries," we urge this Committee to remove from consideration any proposals to levy a "luxury" tax on general aviation aircraft.

## INCREASING AVIATION FUEL TAXES BY FIVE OR TEN CENTS

The Options include a proposal to increase the existing aviation fuel taxes by five or ten cents per gallon. Currently, aviation fuels used for non-commercial purposes are taxed at twelve cents per gallon of aviation gasoline and fourteen cents per gallon of turbine (jet) fuel. The revenues from these taxes are deposited into the Airport and Airway Trust Fund. An additional tax of one-tenth of cent per gallon is imposed for deposit into the LUST Fund. When coupled with the various state and local excise and sales taxes imposed, a significant portion of the cost of a gallon of aviation fuel, which averaged $1.86 for 100LL (100 octane Low-Lead) gasoline and $1.70 for turbine fuel in 1986, is comprised of tax. The proposal found in the Options would increase the Federal tax burden on non-commercial general aviation operators to a maximum of 22.1 and 24.1 cents, a jump of 83% and 71%, respectively, at the Federal level alone. As some states have recently increased their taxes on aviation fuel, operators could well be facing average prices in excess of $2.00 a gallon for aviation gasoline and $1.85 for jet fuel if these proposals are adopted.

In order to adequately explain the inequity of imposing increased fuel taxes on general and business aviation, we must first present some background on the current taxes and the Airport and Airway Trust Fund. As the Committee is aware, the revenues from these taxes are deposited into the Airport and Airway Trust Fund, a funding mechanism dedicated to airport and airway system development. Since the Trust Fund's inception in 1971, it has never been at a deficit. In fact, in most years it has maintained a surplus.

Currently, the unobligated surplus reposing in the Fund amounts to approximately $5 billion. These unobligated funds are providing aviation users, and consequently the economy, absolutely no benefits. In fact, the only purpose served by these unobligated funds is to make the overall budget situation appear, on paper, to be slightly better. Ironically, the instant proposals stem from the same desire; to make the overall budget situation appear slightly better. Thus, another argument against these tax increases is the fact that aviation system users are already contributing to a reduction of the budget deficit through Congress' withholding of these funds from their intended purpose.

Since well before enactment of aviation system improvement legislation in 1982, which increased these taxes to their current rate, aviation users have rightly complained these funds are not being spent for the purposes intended. That they are needed for airport and airway system development certainly comes as no surprise to anyone who has paid attention to the public debate on the adequacy of this nation's air transportation system in recent months. To those who use the system on a daily basis its needs are a painful, often time-consuming, reality. Certainly, frequent flyers such as yourselves need no demonstration that we need to move ahead with the process of modernizing and improving air transportation in this country.

Realizing this, and in attempting to build-in incentives for these much-needed funds to be spent, the House Committee on Public Works and Transportation on June 12 recommended that the House Committee on Ways and Means reauthorize these taxes at their current levels. The Public Works Committee recommended that reauthorizing legislation include a tax reduction "trigger" mechanism, as is found in H.R. 8, to provide automatic reductions in these and other taxes if funding for aviation programs falls below authorized levels. The Public Works Committee continued:

> We believe that a tax trigger would help avoid a repetition of the experience of the past five years in which the revenues contributed by users to the Trust Fund were not fully spent but were used, in effect, to reduce the deficit in the general budget.

Clearly, aviation users such as we represent cannot support and must oppose any proposal which would increase these taxes. This is especially true when the instant proposal calls for these revenues to be allocated to general revenue, not to the already-bloated Airport and Airway Trust Fund. If these taxes are increased further, thereby increasing operating costs, another major disincentive will have been created for those who would seek to use general aviation aircraft for business reasons.

When considering the need to reauthorize aviation fuels taxes, we strongly urge this Committee to discard any notion of increases for the purpose of balancing the budget. Indeed, taxes already levied on aviation users are contributing to the budget-balancing effort to the tune of $5 billion. Instead, we urge retention of the present rates, with the revenues derived from them to be wholly deposited into the Airport and Airway Trust Fund, and inclusion of tax reduction "trigger" mechanism such as that recommended by the House Committee on Public Works and Transportation and endorsed by Senator Wendell Ford, Chairman of the Subcommittee on Aviation. To increase these taxes would be to totally ignore the contributions to the economy made through the use of these aircraft, adversely affect general and business aviation users and have additional drastic affects on an already-moribund manufacturing industry.

## INCREASING THE TAX ON TRANSPORTATION OF PERSONS BY AIR

The Options contain a proposal to increase the existing tax on transportation of persons by air from the current rate of eight percent of its cost to ten percent. Commonly known as the "airline ticket tax", this tax is also paid by air taxi customers, charter groups and, sometimes, on amounts "charged-back" between related companies for the use of their aircraft, in addition to airline passengers.

Given that the revenues generated by this tax are also deposited into the Airport and Airway Trust Fund, our reasons for opposing this proposal are the same as for opposing increases in aviation fuel taxes. This tax should simply be reauthorized at its current level and made subject to the tax reduction "trigger" mechanism as is recommended by the Public Works Committee.

## INCREASING TAXES FOR TRUST OR SPECIAL FUNDS

Another proposal found in the Options would increase Federal excise taxes deposited into trust or special funds such as the Airport and Airway Trust

Fund by 33 percent to offset "implicit contributions" from general revenue to those funds. An additional option includes another increase equivalent to the supposed loss to the Treasury from tax-exempt revenue bonds used to finance related activities. These proposals, if applied to the Airport and Airway Trust Fund, fail in their consideration of the realities of the taxes imposed on aviation system users, how these revenues are used and the long-standing public policy behind them.

The proposal to address so-called "implicit contributions" assumes those paying this tax have the option of whether to purchase air transportation or aviation fuel, in the same manner as one who might purchase tobacco products or alcoholic beverages. That is simply not the case. More than 90% of all inter-city travel in the United States is by air. In addition, when considering the decline of rail transportation in all but the Northeast Corridor, the failing inter-city bus industry and the impracticality of travelling by automobile, even the discretionary traveller has no choice but to fly. Additionally, alternate modes are not viable if the traveller is interested in the fastest means, as business travellers often are. Thus, even if not regressive in the conventional sense, an increase in these taxes for the reasons espoused in the Options is regressive in fact. As these taxes are not generally deductible to an individual, and would not be levied except for the purpose of aviation system development, the concept of "implicit contributions" should not be applied.

The proposal to increase these taxes by an additional amount to offset the supposed revenue loss to the Treasury from tax-exempt bonds also fails to consider the reality of aviation system funding. Even if all funds allocated to the Airport and Airway Trust Fund were immediately spent to improve the system, many billions of dollars in unmet needs would exist. To make up for this shortfall, many airport sponsors and municipalities have had to resort to tax-exempt revenue bonds to finance these much-needed improvements. As Congress has repeatedly approved their use for aviation system development projects and woefully underfunded the Federal improvement programs, it has set forth a policy that they be used in this fashion. Now, the Options would abrogate this policy and penalize aviation system users for a drain on the Treasury brought about by Congress' failure to provide a program of adequate size and scope in conjunction with its long-standing policy that these bonds be used in this fashion. Few actions would undermine the user fee concept, and the faith users have placed in this system for funding aviation improvements, than would adoption of this proposal.

We urge this Committee to abandon such proposals. The "macro-economic mumbo-jumbo" from which they stem fails utterly to consider long-standing Congressional policy in this area as well as the regressive nature such increases would have.

## CONCLUSION

This Committee is faced with a most difficult and, clearly, unpopular task. Your task is no doubt made more difficult by the Joint Committee's inclusion of detrimental and counterproductive proposals such as those we have outlined today. Accordingly, we strongly urge you to discard these proposals for additional taxes on aviation. The revenues involved are insignificant in comparison with the totals required, the economic harm which would be wrought through their enactment would in fact damage the overall deficit reduction effort from which they stem and for which aviation users are already paying, dearly, for very little in benefit.

The overwhelming need to expand and improve airports and modernize the 1950s-era air traffic control system equipment also has implications for the economy and for the budget deficit. As inefficiency becomes the norm and delays and circuitous routings take their toll on productivity and competition, the needs will become even more acute. Even so, the very real requirements for increased productivity and competition in relation to foreign-based industry simply will not be met if general and business aviation are subjected to stifling tax levels such as have been proposed. Instead the result will be the inability of the nation's air transportation system to support the economy's demand for air travel.

Thank you for allowing us to submit this statement. We stand ready to provide this Committee any additional information it may require.

**National Coordinating Committee for Multiemployer Plans**

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July 14, 1987

## COMMENTS OF THE NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS ON TECHNICAL CORRECTIONS NECESSARY TO CLARIFY THE APPLICATION OF THE TAX REFORM ACT OF 1986 TO MULTIEMPLOYER PLANS

Robert A. Georgine, Chairman of the National Coordinating Committee for Multiemployer Plans[1] is pleased to provide these comments on technical corrections that are necessary to clarify the application of the Tax Reform Act of 1986 ("TRA"), to multiemployer plans.

### 1. Vesting.

Internal Revenue Code ("Code") section 411, as added by the TRA generally requires five-year cliff or seven-year graded vesting for qualified retirement plans. There is a multiemployer plan exception permitting ten-year cliff vesting with respect to participants covered by a collective bargaining agreement. However, the statute requires five-year cliff or seven-year graded vesting to be provided for participants who are not covered by a bargaining agreement.

Multiemployer plans often cover employees of the fund and of the related union and sometimes of the association of contributing employers. Clerical employees of the union are often, but not always, covered by collective bargaining agreements. However, fund and association employees and union officers often are not. In addition, some multiemployer plans permit employers who cover their union employees under the plan incidentally to cover salaried or other nonunion employees as well. The new law could be interpreted to require all such nonunion employees to be given five-year cliff or seven-year graded vesting.

Providing this faster vesting to these employees would create serious political problems for the plans. Rank-and-file union employees would feel that it is unfair for plans to provide five-year cliff or seven-year graded vesting to union officers and nonunion participants while providing only ten-year cliff vesting to the rank-and-file union members. The result would be to make the multiemployer plan exemption unavailable as a practical matter.

There is no evidence that Congress, in enacting the TRA, intended to interfere with the longstanding practice of multiemployer plans of covering union, fund, employer association and sometimes, incidentally, other employees on the same basis as employees covered by a collective bargaining agreement. On the contrary, it is most reasonable to treat union, fund, and employee association employees as though they were covered by a collective bargaining agreement, because they are an integral and necessary part of the process of bargaining for retirement benefits.

In addition, the multiemployer plan participants that would benefit from the five-year cliff or seven-year graded vesting rule are exactly the opposite of the type of participants that the rule is intended to protect. Thus, it is not unusual for some union officers and nonunion employees covered by these plans to be more highly paid than the rank-and-file employees covered by collective bargaining agreements.

These problems could be avoided by clarifying that, for this purpose, the term "collective bargaining agreement" includes a participation agreement covering nonunion employees incidental to the plan's coverage of employees covered by a collective bargaining agreement. A participation agreement should be deemed to provide such incidental coverage if: (1) it is entered into by the fund or related union or association of contributing employers on behalf of its employees; or is entered on behalf of nonunion employees by an employer who contributes to the plan for its union employees; and (2) coverage provided under the participation agreement does not reduce the percentage of plan participants who are covered by collective bargaining agreements below 85 percent.

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[1] The NCCMP is a nonprofit, tax-exempt organization established after Congress enacted ERISA in 1974. It consists of representatives of more than 180 pension and welfare plans, or their sponsors, and represents the interests of approximately nine million persons. On behalf of its affiliated plans, and the approximately nine million participants and beneficiaries of multiemployer plans generally, the NCCMP is entirely engaged in monitoring the development -- legislative, administrative, and judicial -- of the laws relating to the structuring and administration of multiemployer pension and welfare plans.

This clarification would make it administratively feasible for multiemployer plans to continue to provide ten-year vesting and would not provide any potential for abuse. Accordingly, we urge you to include the following provisions in the technical corrections to the TRA:

Paragraph (2) of section 411(a) of the Internal Revenue Code is amended by adding at the end thereof a new subparagraph (D) as follows:

> "(D) COLLECTIVE BARGAINING AGREEMENT. -- For purposes of subparagraph (C), the term 'collective bargaining agreement' includes a participation agreement which provides coverage to nonunion employees which is incidental to coverage provided to employees covered by a collective bargaining agreement. Such coverage will be considered incidental if the participation agreement --
>
> > (i) is entered into by the fund (or by any other collectively bargained employee benefit fund covering some or all of the same participants) or related union or association of contributing employers on behalf of its employees or is entered into on behalf of nonunion employees by an employer who also contributes to the plan on behalf of employees covered by a collective bargaining agreement, and
> >
> > (ii) coverage of such nonunion employees does not reduce the percentage of the plan's participants who are covered by collective bargaining agreements below 85 percent.

The 85 percent test described in clause (ii) will be satisfied if at least 85 percent (determined on a plan-wide basis) of the employees who are covered (or whose beneficiaries are covered) under the plan first became eligible for coverage under the plan on account of their being or having been covered by a collective bargaining agreement."

Paragraph (2) of Section 203(a) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1053(a)(2)) is amended by adding at the end thereof a new subparagraph (D) as follows:

> "(D) For purposes of Subparagraph (C), the term "collective bargaining agreement" includes a participation agreement which provides coverage to nonunion employees which is incidental to coverage provided to employees covered by a collective bargaining agreement. Such coverage will be considered incidental if the participation agreement --
>
> > (i) is entered into by the fund (or by any other collectively bargained employee benefit fund covering some or all of the same participants) or related union or association of contributing employers on behalf of its employees or is entered into on behalf of nonunion employees by an employer who also contributes to the plan on behalf of employees covered by a collective bargaining agreement, and
> >
> > (ii) coverage of such nonunion employees does not reduce the percentage of the plan's participants who are covered by collective bargaining agreements below 85 percent.

The 85 percent test described in clause (ii) will be satisfied if at least 85 percent (determined on a plan-wide basis) of the employees who are covered (or whose beneficiaries are covered) under the plan first became eligible for coverage under the plan on account of their being or having been covered by a collective bargaining agreement."

2. Welfare Plan Reserve Limits.

The Deficit Reduction Act of 1984 ("DEFRA") imposed new reserve limits on welfare funds. Medical, life insurance, disability, SUB, and severance pay plans are permitted to have limited reserves not in excess of specified "account limits." Other plans are not permitted to have any reserves at all.

Employer contributions are not fully deductible if these limits are exceeded. Further, they may not be fully deductible in certain other circumstances, e.g., where the fund uses the contributions to purchase a "facility" with a useful life of more than a year. Also, under Code section 512(a)(3)(E), plan income will be subject to unrelated business taxable income ("UBTI") tax to the extent it increases reserves above permissible levels and to the extent of post-retirement medical benefit reserves.

Recognizing the unique characteristics and needs of collectively bargained plans, Congress provided in DEFRA for Treasury to promulgate, by July 1, 1985, special higher reserve limits applicable to such plans. However, Treasury was unable to devise workable limits. It therefore issued regulations deferring the effective date of the new rules with respect to such plans until final regulations with respect to such limits could be issued. Those regulations explicitly state that neither contributions to nor reserves of such plans shall be treated as exceeding the otherwise applicable limits of Code sections 419(b), 419A(b) (relating to deductibility limits), or 512(a)(3)(E) (relating to UBTI tax). This, in effect, provided a complete exemption for collectively bargained plans for an indefinite period.

Congress recognized, however, that this was not a satisfactory long-term solution to this problem. Plans, in designing their contribution and funding programs, need more certainty with respect to applicable rules. Accordingly, it amended Code section 419A(f)(5) to provide an exception from the reserve limits for collectively bargained plans as follows:

> "(5) Special Rule for Collective [sic] Bargained . . . Plans. -- No accounts [sic] limits shall apply in the case of any qualified asset account under a separate welfare benefit fund --
>
> (A) Under a collective bargaining agreement, . . ."

The clear intent of this provision, reflected in the Finance Committee's report on its bill, which contained almost identical language, was that "employer contributions to such VEBAs are deductible and earnings on assets of such VEBAs are tax-exempt." S. Rep. No. 313, 99th Cong. 2d Sess. 1010 (1986). Any more narrow interpretation would cut back on the preexisting regulatory exception -- a result which was clearly not intended by Congress. Further, the special nature and characteristics of collectively bargained plans makes a complete exemption necessary and appropriate. In particular, the nature of such plans, and of the collective bargaining process, generally precludes the abuses of principal concern. Also, the practical requirements of multiemployer plans, e.g., the need to set contributions at some fixed rate (based on hours of work or units of production) and the plans' basic economics,[2] mandate special reserve principles.

However, the statutory language cited above could be construed to fail to accomplish the intended result fully for the following reasons:

> (i) The language "no account limits shall apply in the case of any qualified asset account" could be construed to limit the exception to benefits for which qualified asset accounts may be maintained under section 419A(a), i.e., disability, medical, SUB or severance pay, and life insurance benefits. Thus, no relief would be provided for other funds, such as group legal or educational assistance.
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> (ii) The statutory language could be construed simply to increase permissible reserve limits. This would not correct certain anomalies such as the inability of employers

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[2] Employer contributions to multiemployer plans generally do not rise to meet plan needs in the absence of a negotiated change to a collective bargaining agreement. Instead, because they are generally linked to levels of covered work, they tend to fall in times of aggravated participant need, e.g., recession, layoff, or industry decline.

contributing to collectively bargained plans to deduct fully contributions used by the fund to purchase facilities with a useful life of more than one year. This would create special problems for multiemployer plans which, because they are separate and distinct entities from the contributing employers, must maintain their own separate facilities.

(iii) In addition, it could be argued that the statutory language does not address the imposition of UBTI tax on post-retirement medical benefit reserves under Code section 512 -- despite the fact that, as a policy matter, the imposition of this tax on reserves of funds permitted to maintain unlimited medical benefit reserves for active participants is clearly nonsensical.

Accordingly, to clarify the intended result of the statutory exception, we suggest that the following provisions be included in the technical corrections to the TRA:

Paragraph (5) of section 419A(f) is amended to read as follows:

"(5) Treatment of Collectively Bargained Funds --

"(A) In General. -- Neither contributions to nor reserves of a collectively bargained welfare benefit fund shall be treated as exceeding the otherwise applicable limits of section 419(b) or subsection (b) of this section.

"(B) Collectively Bargained Welfare Benefit Fund -- For purposes of subparagraph (A), the term 'collectively bargained welfare benefit fund' means a fund --

"(i) which is maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers,

"(ii) with respect to which there is evidence of good faith bargaining over the benefits provided through the fund, or the funding for those benefits, and

"(iii) which satisfies paragraph (C) below.

"(C) A welfare benefit fund satisfies this paragraph if --

"(i) At least 85 percent of the employees who are eligible (or whose beneficiaries are eligible) to receive benefits under the fund first became eligible for coverage under the plan on account of their being or having been covered by a collective bargaining agreement.

"(ii) For purposes of (i) above, employees of the fund (or of any other collectively bargained employee benefit fund covering some or all of the same participants), sponsoring union or an association of contributing employers shall be deemed to be covered by a collective bargaining agreement."

Clause (i) of section 512(a)(3)(E) is amended by inserting after the words "In the case of an organization described in paragraph (9), (17) or (20) of section 501(c)" the words "(except for a collectively bargained welfare benefit fund, as defined in section 419A(f)(5)(B))."

### 3. Nondiscrimination Rules

#### a. Retirement Plans

Under the TRA, three alternative coverage tests apply to qualified retirement plans. All of these involve computing a percentage based on information about "highly compensated employees." They are as follows:

(i) 70 percent of all nonhighly compensated employees must be covered by the plan;

(ii) The percentage of nonhighly compensated employees covered by the plan must be at least 70 percent of the percentage of highly compensated employees covered; or

(iii) The group of employees covered by the plan must satisfy the present law nondiscriminatory classification test and the average benefit provided to nonhighly compensated employees (whether or not included in the plan), as a percentage of compensation, must be at least 70 percent of the average benefit provided to highly compensated employees (whether or not included in the plan), as a percentage of compensation.

In general, for this purpose, "highly compensated employees" include: (1) five percent owners; (2) employees earning over $75,000 per year; (3) employees earning over $50,000 per year who are in the top twenty percent of the employer's employees by compensation; and (4) officers earning over $45,000 per year (indexed for inflation).[3] However, if no officer satisfies this compensation requirement, the highest-paid officer will be treated as a highly compensated employee.

Multiemployer plans would, as a substantive matter, have no problem in satisfying these tests, but would, as a practical matter, rarely be able to demonstrate their compliance. The vast majority of participants of such plans are union-represented, rank-and-file employees who are not officers, owners, or highly paid. Further, multiemployer plans typically provide flat dollar benefits based only on years of service and unrelated to compensation. As a percentage of compensation, benefits under such plans are therefore disproportionate in favor of nonhighly compensated employees. Thus, such plans are not discriminatory.

However, it would be virtually impossible for these plans to prove that they satisfy any of the above percentage tests. This is because they typically do not have the information about the ownership, management, and compensation structure of contributing employers necessary to identify highly-compensated employees. Nor would contributing employers ordinarily be willing to provide this data to plan trustees, fifty percent of whom are required by law to be union representatives, and the other fifty percent of whom are generally highly-placed in the management structure of their competitors. Thus, permitting plan trustees access to data necessary to determine their plan participants' rank on employers' pay scales, or expanding employer recordkeeping and reporting requirements to the extent necessary to maintain up-to-date records on aggregate employee compensation would create significant problems in collective bargaining.

Indeed, many multiemployer plan participants work for several contributing employers during a year. Plans would be unable to determine, with respect to such employees, which employer's employees would serve as the group with respect to which the twenty percent test must be satisfied.

Also, total annual compensation of employees covered by multiemployer plans typically depends heavily on the number of hours the individual works during the year, including overtime, holiday, and other premium pay, and the hourly rate paid. A worker paid at a relatively high hourly rate will, nevertheless, have a fairly modest annual compensation from covered service if there are significant portions of the year during which he does not, or is unable to, secure employment in the plan's jurisdiction. On the other hand, a participant paid at a fairly modest hourly rate may have a comparatively high annual compensation if he is employed during all of the year and works a significant number of overtime hours. Moreover, the hourly rate paid and number of hours worked may vary widely for the same participant from year to year. Multiemployer plans often do not have access to this data. Thus, such plans would be unable even to determine the compensation levels of particular participants for a year, much less compare those levels to levels earned by nonparticipating employees of contributing employers to determine which are highly compensated.

Multiemployer plans would therefore usually be unable to compute the percentages necessary to prove that they satisfy any of the three seventy percent tests described above. Also, as discussed above, attempts by trustees to gather the information necessary to compute the percentage tests could prove disruptive for bargaining relations. Nevertheless, as discussed, such plans are not discriminatory. Accordingly, it is both important and appropriate to apply the new rules to multiemployer plans in a workable fashion which does not require them actually to compute percentages.

To help solve these problems, we urge you to provide a presumption that multiemployer plans satisfy the nondiscrimination rules and need not compute percentages to prove their compliance, except in specifically identified abuse situations. We suggest that you include the following provision in the technical corrections to the TRA for this purpose:

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[3] For this purpose, no more than 50 employees (or, if lesser, the greater of 3 employees or 10 percent of the employees) are treated as officers.

Subparagraph (F) of Paragraph (6) of Section 410(b) of the Internal Revenue Code is amended by adding at the end thereof a new sentence as follows:

> "Multiemployer plans shall be conclusively presumed to satisfy the nondiscriminatory coverage tests of this subsection and will not be required to compute percentages to demonstrate their compliance, except in situations, if any, specifically identified as abusive in such regulations.

In addition, we urge you to clarify in legislative history, if not in the statute, that employers can take credit for collectively bargained coverage when testing their nonbargained plans for nondiscriminatory coverage.

b. Welfare Plans.

Code Section 89, as added by section 1151 of the TRA, also imposes new nondiscrimination rules on statutory employee welfare benefit plans. Very generally, such plans must satisfy both an eligibility test and a benefit test. To demonstrate compliance with these tests, plan trustees would have to compare eligibility and benefit percentages for highly compensated employees with those of nonhighly compensated employees. As discussed above in the context of retirement plans, multiemployer plans are not discriminatory and, as a substantive matter, would have no trouble complying with the new nondiscrimination rules. Nevertheless, it ordinarily would be virtually impossible for such plans to demonstrate their compliance. As noted, this is because they typically do not have access to the information necessary to identify highly compensated employees and compute the required percentages.

To address these problems, we urge you to provide, in the context of welfare plans, a presumption similar to that discussed above with respect to retirement plans. We suggest the following language:

Subsection (m) of Section 89 of the Internal Revenue Code is amended by adding at the end thereof a new sentence as follows:

> "Multiemployer plans will be conclusively presumed to satisfy the nondiscrimination tests of this section and will not be required to compute the percentages necessary to demonstrate such compliance, except in situations, if any, specifically identified as abusive in such regulations."

In addition, we urge you to make clear in legislative history, if not in the statute, that employers can take credit for collectively bargained coverage when testing their nonbargained plans for nondiscrimination.

4. Section 415 Limit on Benefits
Under a Defined Benefit Plan.

The TRA amends Code section 415(b)(5) to provide that the $90,000 (indexed) limit on benefits under a defined benefit plan is phased in over ten years of participation in the plan, instead of over ten years of service, as under prior law. The limit is required to be phased in separately with respect to benefit increases.

However, the term "year of participation" is not defined in the statute. This has led to confusion and an unjustifiably narrow interpretation by the Internal Revenue Service.

Accordingly, we urge you to define year of participation for this purpose as any year during which an employee is at any time eligible to participate in the plan or during which an employee has at any time a vested present or future right to receive benefits under the plan. Statutory history should make clear that, under this definition, a full year of participation may be credited for a year during which the participant has insufficient service to accrue a benefit, to earn credit for vesting, or to avoid a break in service, or during which the participant is a terminated vested employee or a retiree.

We note that this is inconsistent with IRS Advance Notice 87-21, which states that a participant will be credited with a year, or partial year, of participation only for an accrual computation period during which:

(1) the participant is credited with at least the number of hours of service, or period of service if the elapsed time method is used for benefit accrual purposes, required under the terms of the plan to accrue a benefit for the accrual computation period; and (2) the participant is included as a participant under the eligibility provisions of the plan for at least one day of the accrual computation period. Even if these two conditions are met, according to the notice, the participant will be credited only with that portion of a year of participation that equals the amount of benefit accrual service credited to the participant for the accrual computation period. Thus, for example, if, under the terms of a plan, a participant receives one-tenth of a year of benefit accrual service for an accrual computation period for each 200 hours of service, and the participant is credited with 1,000 hours of service for the period, the participant will be credited with one-half a year of participation for purposes of section 415(b).

This is an unjustifiably narrow definition of the term "participation". It would exclude individuals who participate in the plan, earn sufficient service credit to avoid having a break in service, but do not have sufficient service credit to earn benefit accruals -- *i.e.*, for most plans, individuals having more than 500 but less than 1,000 hours of service. It would also exclude terminated vested employees and retirees. All of these employees are clearly participants for many purposes of ERISA.

Their exclusion would not further, and in fact would frustrate, Congress' expressed purpose in modifying section 415. That purpose was to require employers, as a condition of providing the maximum benefits for highly compensated employees, to establish their plans at least ten years prior to the date such highly compensated employees retire, thus providing an opportunity for other employees to accrue (and become vested in) greater benefits.[4] This goal will be achieved if the maximum benefit limit is phased

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[4] For example, the Senate Finance Committee Report states as follows:

> In addition, the Committee is concerned that the rule requiring reduced limits on benefits payable to participants with fewer than ten years of service is not effectively limiting benefits for highly compensated employees with short periods of plan participation. The Committee is aware that some employers are able to plan the timing of the establishment of a defined benefit plan (or an increase in benefits under a preexisting plan) to coincide with projected retirement of one or more of the employer's higly compensated employees. The effect of this delay is to avoid providing a comparable level of benefits to other employees who may have retired before the highly compensated employees. If, on the other hand, the defined benefit pension plan was established earlier so that the highly compensated employees accrued the maximum benefit over a longer period of service, rank-and-file employees would have accrued (and become vested in) greater benefits. Thus, the Committee finds it appropriate to require ten years participation in a defined benefit pension plan before the maximum benefits can be provided." S. Rep. No. 313, 99th Cong., 2d Sess., 623 (1986).

Similarly, the House Report provides as follows:

> "In addition, the Committee is concerned that the rule requiring reduced limits on benefits payable to participants with fewer than ten years of service is not effectively limiting benefits for highly compensated employees with short periods of plan participation. The Committee is aware that some employers time the establishment of a defined benefit plan (or an increase in benefits under a preexisting plan) to coincide with projected retirement of one or more of the employer's highly compensated employees. The effect of this delay is to avoid providing a comparable level of benefits to other employees who have retired prior to the highly

[Footnote continued on next page]

in over a ten-year period beginning on the date the employee initially becomes entitled to participate in the plan regardless of the employee's participation, service, benefit accrual, or other performance during that period. Imposing a more restrictive definition of "participation" is unnecessary and may adversely affect many of the nonhighly compensated employees -- e.g., retirees and terminated vested employees -- Congress intended the modification to benefit.[5]

We therefore urge you to include the following provision in the technical corrections to the TRA:

Paragraph (5) of Section 415(b) of the Internal Revenue Code is amended by adding a new subparagraph (E) at the end thereof as follows:

> "(E) YEAR OF PARTICIPATION DEFINED -- For purposes of this paragraph, a year of participation shall include any year during which an employee is at any time eligible to participate in the plan or during which an employee has at any time a nonforfeitable present or future right to benefits under the plan."

We suggest that the following language be included in legislative history explaining this provision:

> "Section 415(b)(5) requires the $90,000 (indexed) limit on benefits under a defined benefit plan to be phased in over ten years of participation in the plan and requires that limit to be phased in separately with respect to each benefit increase. For this purpose, a 'year of participation' includes any year during which an employee is at any time eligible to participate in the Plan or during which an employee has at any time a vested present or future right to receive benefits under the Plan. Thus, for example, a participant may be credited with a full year of participation for a year which is not yet completed, a year during which he or she has insufficient service to accrue a benefit, to earn vesting credit, or to avoid a break in service, or a year during which he or she is a terminated vested employee or a retiree."

In the event that you do not agree with the foregoing, we note that the Code includes break-in-service rules for determining when a participant can be required to start earning credit over again in order to participate. It would surely be anomalous to treat participants having sufficient service to avoid a break-in-service under the plan as failing, for 415 purposes, to participate in that particular year. We therefore urge you to provide, at a minimum, that participants having sufficient hours of service to avoid a break-in-service shall be treated as participants for purposes of section 415. A more restrictive, and less adequate, approach would be to provide that participants having the lesser of 1,000 hours of service or the minimum hours necessary under the plan for a year of vesting credit shall be treated as participants for purposes of section 415.

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[Footnote continued from previous page]

compensated employee. If, on the other hand, the defined benefit pension plan was established earlier so that the highly compensated employee accrued the maximum benefit over a longer period of service, rank-and-file employees would have accrued (and vested in) greater benefits. Thus, the Committee finds it appropriate to require ten years of participation in a defined benefit paension plan before a participant can receive the maximum benefit." H. Rep. No. 426, 99th Cong., 1st Sess., 740-41 (1985).

[5] We also note that the definition of "participant" in Notice 87-21 is far more restrictive than the definition of "active participant", as set forth in Notice 87-16, which provides guidance with respect to individual retirement accounts. Notice 87-16 states that an individual is an "active participant" for a year if he is not excluded under the eligibility provisions of the plan, regardless of whether the individual has elected to decline participation in the plan, has failed to make a mandatory contribution specified under the plan, or has failed to perform the minimum service required to accrue a benefit under the plan.

## 5. Applicability of Joint and Survivor Annuity Requirements to "Auxiliary" Disability Benefits.

Section 1898(b)(12)(A) of the Technical Corrections to the Retirement Equity Act of 1984 ("REA"), contained in the TRA amended Code section 417(f) to apply the joint and survivor rules to a disability benefit only if such benefit is not an "auxiliary" benefit. The Finance Committee's report provides an adequate definition of auxiliary benefit. The Finance Committee Report states:

> "If a participant receiving a disability benefit will, upon attainment of early or normal retirement age, receive a benefit that satisfies the accrual and vesting rules of section 411 (without taking the disability benefit payments up to that date into account), the disability benefit may be characterized as auxiliary.[6]

This definition should be incorporated into the legislative language to make its applicability clear.

In addition, the statute should make clear the point at which a joint and survivor annuity must or may be offered with respect to participants receiving auxiliary disability benefits. Applicable time frames for joint and survivor notices and elections should also be clarified. For example, will the recipient of an auxiliary disability benefit automatically begin receiving an actuarially reduced joint and survivor benefit at normal retirement age if he does not properly elect otherwise within 90 days prior to that time? In a plan offering an early retirement benefit, will the joint and survivor benefit begin, as it appears to us it should, at early rather than normal retirement age?

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[6] That report gives the following examples of the application of this definition:

> For example, consider a married participant who becomes disabled at age 45 with a deferred vested accrued benefit of $100 per month commencing at age 65 in the form of a joint and survivor annuity. If the participant is entitled under the plan to a disability benefit and is also entitled to a benefit of not less than $100 per month commencing at age 65, whether or not the participant is still disabled, the payments made to the participant between ages 45 and 65 would be considered auxiliary. Thus, the participant's annuity starting date would not occur until the participant attained age 65. The participant's surviving spouse would be entitled to receive a qualified preretirement survivor annuity if the participant died before age 65, and the survivor portion of a qualified joint and survivor annuity if the participant died after age 65. The value of the qualified preretirement survivor annuity payable upon the participant's death prior to age 65 would be computed by reference to the qualified joint and survivor annuity that would have been payable had the participant survived to age 65.
>
> If, in the above example, the participant's benefit payable at age 65 were reduced to $90 per month as a result of the disability benefits paid to the participant prior to age 65, the disability benefit would not be auxiliary. The benefit of $90 per month payable at age 65 would not, without taking into account the disability benefit payments prior to age 65, satisfy the minimum vesting and accrual rules of section 411 of the Code. Accordingly, the first day of the first period for which the disability payments were made would constitute the participant's annuity starting date, and any benefits paid the participant would be required to be paid in the form of a qualified joint and survivor annuity (unless waived by the participant with the consent of the spouse)." S. Rep. No. 313, 99th Cong. 2d Sess. 1094 (1986).

The statute should also expressly permit plans that have already been amended to provide joint and survivor annuities with respect to auxiliary disability benefits -- thus complying with REA as in effect prior to this technical correction -- to adopt amendments eliminating such annuities without running afoul of the REA anti-cutback rules. Otherwise, plans that acted promptly to comply with REA would be penalized as compared to plans that did not. We suggest that the following provision be added to the technical corrections to the TRA for this purpose:

(1) Special rule for Plans Providing Joint and Survivor Annuities with Respect to Auxiliary Disability Benefits as of the Date of Enactment of this Act. --

(i) Elimination of Joint and Survivor Form. Plans providing joint and survivor annuities with respect to auxiliary disability benefits as of the date of enactment of this Act may be amended, prior to the beginning of the first plan year beginning on or after January 1, 1989, to eliminate such joint and survivor benefits as to benefits not then in pay status.

(ii) Coordination with Internal Revenue Code section 411(d)(6), and section 204 of the Employee Retirement Income Security Act of 1984 -- An Amendment made pursuant to this subparagraph shall be deemed to satisfy the requirements of section 411(d)(6) of the Internal Revenue Code and section 204 of the Employee Retirement Income Security Act of 1974.

6. Effective Dates.

Many of the employee benefit provisions of the TRA provide extended effective dates for collectively bargained plans. However, most of these extensions apply only with respect to employees covered by a collective bargaining agreement. These include the: $7,000 limit on elective deferrals (TRA § 1105(i); minimum vesting standards (TRA § 1113(e)); minimum distribution requirements (TRA § 1121(d)); and nondiscrimination rules for coverage and benefits under certain statutory employee benefit plans (TRA § 1151(k)).

The purpose of the extension is to avoid requiring plan amendments before expiration of bargaining agreements, thereby forcing such agreements to be reopened and renegotiated. However, until subsequent negotiations determine the details of amendments with respect to bargaining unit participants, it will be impossible to draft amendments providing the same treatment for nonunion participants. In addition, application of new rules which inherently require all plan participants to be considered together, such as the welfare plan nondiscrimination rules, on a bifurcated basis would be impossible. Thus, the effect of the bifurcated effective date would, as a practical matter, likely to be thwart the intent of the extended effective date provisions.

Accordingly, we urge you to apply the extended effective dates for collectively bargained plans to all participants of such plans.

* * *

We appreciate your time and attention to these extremely important multiemployer issues. If you have any questions or if we can be of further help, please call Vivian Berzinski (202) 872-8610, or K. Peter Schmidt (202) 872-6834, of our professional staff.

## Statement of

## REPRESENTATIVE PATRICK A. SWEENEY

## HOUSE MAJORITY WHIP

## OHIO GENERAL ASSEMBLY

## ON BEHALF OF THE

## NATIONAL CONFERENCE OF STATE LEGISLATURES

*The following statement is submitted for the record by Representative Patrick A. Sweeney, Majority Whip of the Ohio House of Representatives, on behalf of the National Conference of State Legislatures (NCSL).*

Mr. Chairman, we in the nation's state legislatures understand the urgent need to address the federal budget deficit, and we support your efforts to do so. We know that both the Administration's budget proposal and the Congressional Budget Resolution call for raising additional revenue. In raising the $19.3 billion which the Budget Resolution requires, we urge you to reject any measure that would disrupt intergovernmental fiscal relations and impair the ability of state government to meet its responsiblities to our shared constituencies. Eliminating the deficit is important to all of us, but shifting fiscal problems from one level of government to another is not a valid solution.

Specifically, we are concerned about proposed federal revenue measures that would intrude upon state revenue bases and those that would violate principles of federalism by treating states as commercial enterprises subject to ordinary taxation.

### Federal Revenue Measures and State Fiscal Conditions

Throughout this decade, states have been called upon to assume increasing responsibilities in the provision of vital public services to the American people. We have accepted that responsibility, though federal actions have impinged on the ability of states to adequately finance their activities. At the same time, a misconception has arisen among some at the federal level to the effect that the fiscal condition of the states is so strong that states can be expected to shoulder a disproportionate share of the burden of deficit reduction without adversely affecting services.

In reality, the fiscal condition of the states varies widely. During fiscal 1987, 24 states had to cut their budgets in mid-year. (See attached map.) Several states have experienced two or more consecutive years of budget cuts along with tax increases. States in economically distressed regions have encountered concomitant fiscal difficulties. Where the economy is dependent upon energy production, agriculture, and manufacturing problems have been particularly acute. In no region are conditions extremely strong. In FY '86 the 50 states had average budget balances of 2.7 per cent; the benchmark generally accepted as a measure of fiscal soundness is 5 per cent. An NCSL study concluded that,

> The margin of safety separating states from serious fiscal problems is shrinking. If the economy experiences a recession or slows down further, many states will be in fiscal difficulty because their reserve balances are not large. ["State Budget Actions in 1986".]

## State Fiscal Constraints

Mr. Chairman, it is important to know that states operate within much more stringent fiscal constraints than does the federal government.

The states impose some of this fiscal discipline on themselves. For example, 49 states have constitutional or statutory requirements that their budget must be balanced. Other constraints are found in the U.S. constitution -- for example, states cannot conduct a monetary policy because they cannot print money. Perhaps most importantly, the federal government restricts the ability of states to raise tax revenue. The U.S. Supreme Court long has interpreted the commerce clause of the Constitution to restrict state taxes that allegedly interfere with interstate commerce. In 1967, for instance, the court forbade states from requiring collection of a sales tax on out-of-state sellers in the *National Bellas Hess* case. (In light of the change of national buying patterns, we are urging Congress to overturn that decision).

Two court decisions this year placed even greater restrictions on state taxes. In a Pennsylvania case, the court struck down a fee on motor carriers. The court also abrogated a Washington business and occupation tax, and losing it will probably require restructuring the state's tax system.

These, Mr. Chairman, are only the legal constraints on state revenue systems. There are many practical factors that limit states' use of certain taxes. For example, the federal government's heavy reliance on the income tax substantially limits its use by states.

I hope, Mr. Chairman, that the members of this Committee will keep in mind these limitations on revenue sources available at the state and local level when considering various proposals to raise revenue at the federal level.

## Excise Taxes -- Encroachment on State Revenue Sources

NCSL is very concerned about proposals to expand the federal government's intrusion into traditional sources of state revenue. Many of the options contained in the handbook prepared for these hearings by the staff of the Joint Committee on Taxation ("Description of Possible Options to Increase Revenues" -- JCS-17-87) do precisely this.

An increase in federal excise taxes would limit state's ability to resort to such taxes when necessary. [II.A.1-2.] Furthermore, states would immediately suffer reduced yields on their own sales taxes on corresponding commodities. NCSL estimates that doubling the cigarette tax, for instance, would cost states $257 million in the first year. Increasing the federal excise rates on beer and wine to the alcohol-equivalent of the tax on distilled spirits would cost states about $140 million. Another $88 million would be lost if the tax on distilled spirits were raised from the current $12.50 to $15.00 per proof gallon. (See attached chart and tables).

## Gas Tax Especially Objectionable

Perhaps the most objectionable excise tax proposal is the suggestion that a new excise tax on motor fuels be levied, with the additional revenue being used entirely for deficit reduction, rather than for transportation purposes. [II.A.8.] A 10 cent per gallon increase (which would more than double the present federal tax) would reduce state motor fuel tax collections by $232 million the first year. In subsequent years the revenue drain would increase, so that by the fifth year state collections would be down by almost a billion dollars annually. Over the first five years, states treasuries would lose $3.3 billion. (See attached chart and tables).

The reduction in funds available for the nation's transportation needs would not, however, be limited to the direct loss to the states. Funds from the existing, dedicated tax, which flow into the highway trust fund, would be reduced by $2.6 billion over five years. (See attached chart and tables). In other words, the total loss in funds available for transportation purposes from a 10 cent per gallon, non-dedicated, tax increase would be about $6 billion over five years. This loss would come at a time when many states have undertaken massive new initiatives to rebuild the country's transportation infrastructure. Since the last increase in the federal rate five years ago, 40 states have increased their own gas taxes, 11 this year.

The imposition of such a tax would represent a radical departure from the "user fee" concept which has governed the federal motor fuel tax since the inception of the Interstate Highway Trust Fund; it would be an abrogation of a state-federal partnership in transportation which has served the country well for over thirty years. Mr. Chairman, states were willing to support the increase in the federal rate in 1982 on the understanding that all the revenue would continue to be dedicated to the Trust Fund. Since that time, Congress and the Administration have persistently withheld money in the fund from the states, maintaining a balance in the fund as a "paper offset" to the deficit. A new tax displacing revenue from transportation purposes would further undermine intergovernmental cooperation in this vital area.

### Value Added Tax

In recent years there has been much speculation about a national tax on consumption, either a sales tax or a value added tax. There are some who believe that Congress would seriously consider such a levy if annual deficits continue their current pace.

The enactment of such a tax would be wrong for several reasons. First, and most significantly, is the negative impact such a tax would have on state tax bases. States still rely on the sales tax as a major source of revenue, notwithstanding the loss of deductibility in last year's tax legislation. To illustrate, ten years ago the average rate of sales tax among the states was 4 percent; today the average rate is 5 percent. To force a national sales or value added tax would further compromise the fiscal integrity of state governments and complicate the interaction of state and federal tax systems. Such a tax would also create additional compliance problems for community and small businesses and add a substantial layer of bureaucracy to oversee the new system. In sum, VAT is a bad idea and ought to be given a quick dismissal.

### Tax Policy and Federalism

Any proposal to limit the deductibility of state and local taxes against federal income taxes violates the principle of intergovernmental reciprocal immunity from taxation, which we see as a fundamental part of federalism. Elimination of the deduction for state sales tax in last year's tax bill was an unfortunate departure from this principle. New proposals to disallow the deduction for personal property taxes, impose a floor under itemized deductions, or to limit tax-liability reduction represent a further potential encroachment on the fiscal integrity of state and local government. Furthermore, since states vary greatly in their use of personal property taxes, such a measure would have very disproportionate effects among states. [II.D.3.c.]

Changes in tax-exempt financing that were part of the Tax Reform Act of 1986 had a direct impact on state and local governments. Placing volume caps on the issuance of bonds, requiring the rebate of arbitrage earnings and reclassifying types of public purpose bonds all had an effect on the ability of states to fund public activities.

Among the provisions of tax reform that raised constitutional, as well as financial, questions was the imposition of the alternative minimum tax on certain private activity bonds. [II.D.15] The constitutional questions will be addressed in court. However, Congress need not wait for a Court decision to reflect on the damage to intergovernmental relations caused by an unwise policy. The alternative minimum tax raises the cost of issuance for state and local governments, and hampers flexibility in forming partnerhsips that help fulfill public purposes. Taxing the interest from supposedly tax-exempt bonds undercuts a principle of reciprocal tax immunity that contributes to the fiscal integrity of the states.

To revisit a part of tax reform that raises serious constitutional and policy questions and then to make its provisions more burdensome for state and local governments is not the proper course to take to reduce the deficit.

Another measure that threatens state and local government is the proposal that excise taxes be increased to offset the "revenue loss" from outstanding tax-exempt bonds. [II.A.10.2.] Mr. Chairman, the financial instruments of state and local governments are either tax-exempt, or they are not. The attempt to place any kind of tax on them not only imposes further fiscal difficulties on state government; it indicates a degree of disrespect for the role of states as independent sovereigns within our federal system. The same must be said of the proposal, put forward by the Administration, to require state and local governments to pay federal motor fuel taxes. [I.B.2.]

Finally, the proposed mandatory extension of Medicare coverage to all employees of state and local governments poses a serious violation of the 1985 agreement to phase-in Medicare coverage to all newly hired employees after May 31, 1986, reached by the Administration, Congress and the States in the Consolidated Omnibus Budget Reconciliation Act of 1985. This proposal would put an immediate, additional expense on state budgets of $1.5 billion. For the 4 to 5 million low-to-moderate income employees of state and local governments, the mandatory extension of coverage would effectively eliminate the tax relief promised in the Tax Reform Act of 1986. Such a proposal does not take into consideration the fiscal conditions of the states or their employees, nor the need for gradual change to accomodate state and individual economic constraints. [I.A.1]

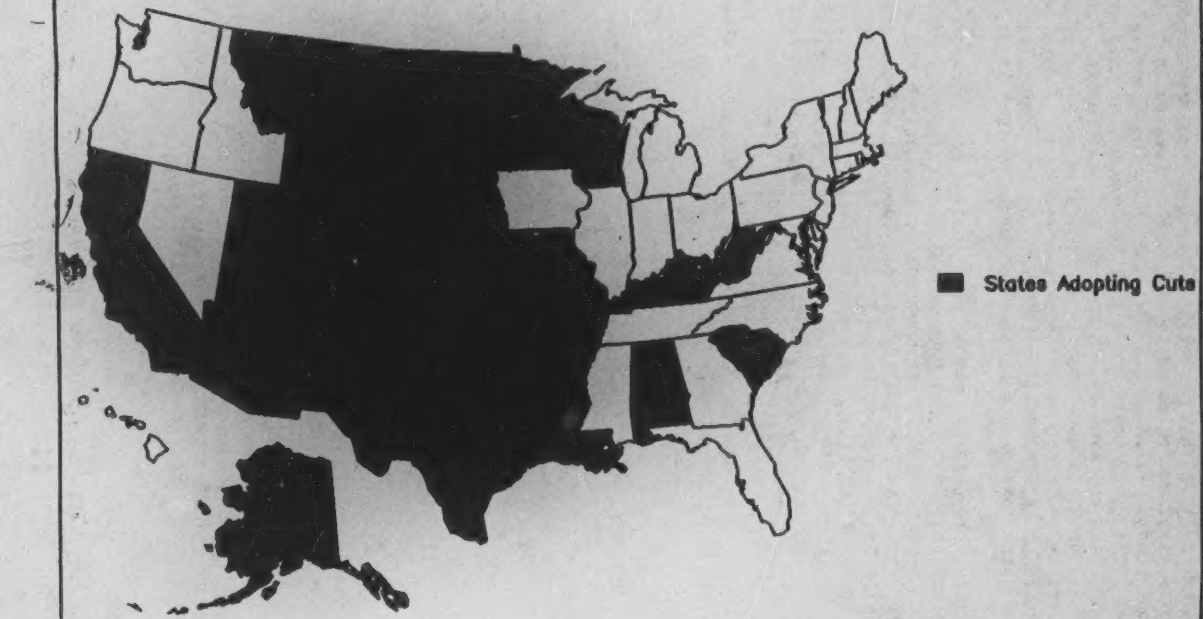
## Conclusion

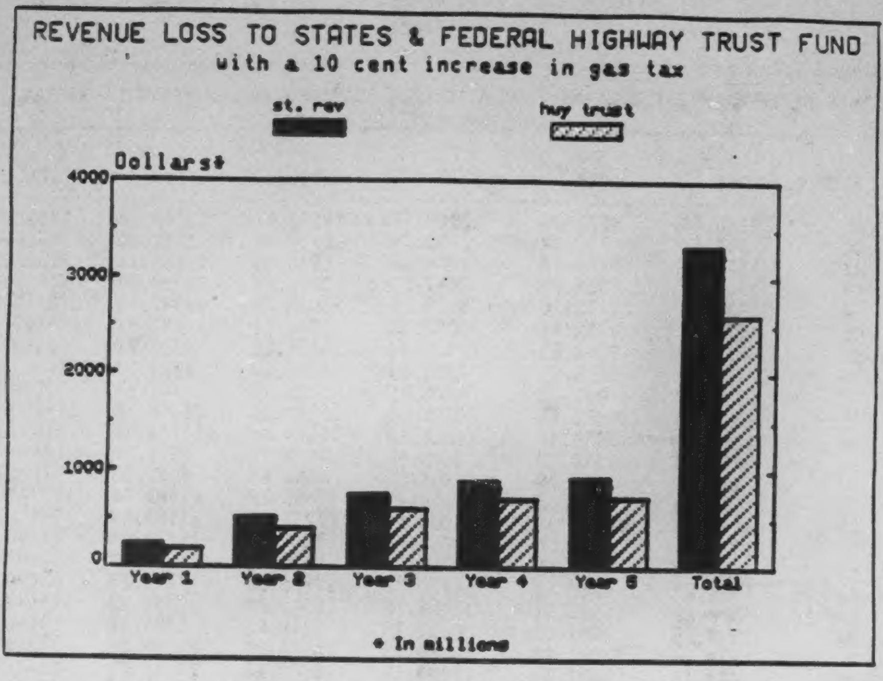
Mr. Chairman, we in state government stand ready to bear our share of the burden in the effort to reduce the deficit. Over the past several years state and local government has in fact, taken a disproportionate share of federal cutbacks. The National Conference of State Legislatures has made constructive proposals addressing the deficit dilemma, on both the spending side and on the revenue side. We have repeatedly signalled our willingness to have the entire budget, save means-tested entitlements, subjected to scrutiny. Our belief is that this approach is necessary to ensure that the burden of budget cuts will be spread equitably.

Similarly, if revenue must be raised, we believe that all revenue options that respect the principle of intergovernmental reciprocal immunity from taxation should be open for Congressional consideration. As we have stated in the past, we believe that the federal government should continue to rely on corporate and individual income taxes for its principal source of revenue.

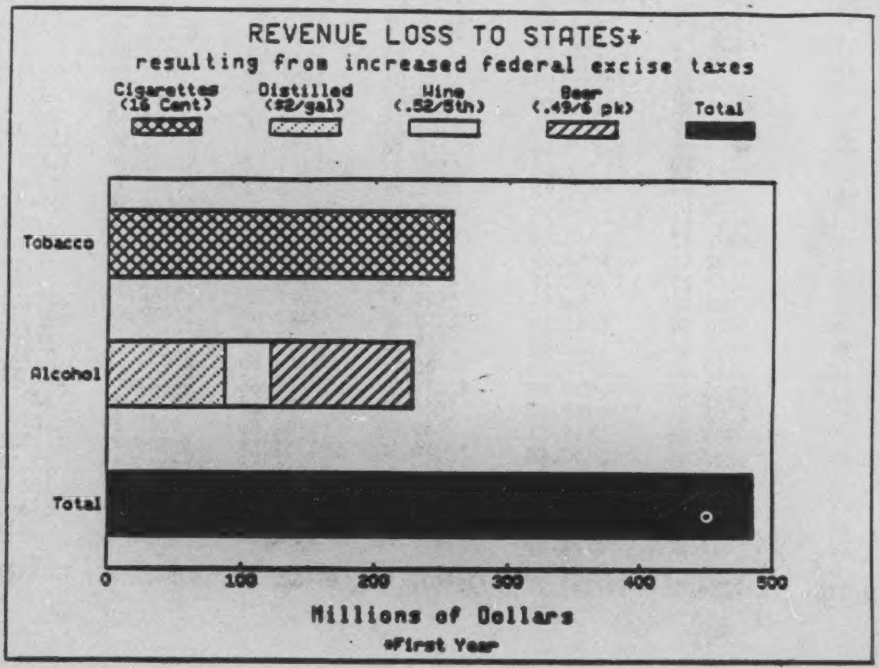
Bearing in mind the precarious fiscal condition of many states, and the constrained fiscal environment in which states must operate, we ask you not to enact measures which encroach upon the ability of state and local government to meet traditional and growing responsibilities.

STATE BUDGET CUTS ADOPTED IN THE FISCAL 1987 BUDGET


▇ States Adopting Cuts



REVENUE LOSS TO STATES & FEDERAL HIGHWAY TRUST FUND
with a 10 cent increase in gas tax



REVENUE LOSS TO STATES*
resulting from increased federal excise taxes

### Table I

## STATE REVENUE LOSS RESULTING FROM A 10 CENT INCREASE IN THE FEDERAL GAS TAX

(In thousands of dollars)

| STATE | 1988 | 1989 | 1990 | 1991 | 1992 | TOTAL |
|---|---|---|---|---|---|---|
| AL | 3760.58 | 8273.29 | 12284.57 | 14540.93 | 15042.34 | 53901.71 |
| AK | 343.10 | 754.82 | 1120.79 | 1326.65 | 1372.40 | 4917.77 |
| AZ | 4366.54 | 9606.38 | 14264.03 | 16883.95 | 17466.15 | 62587.05 |
| AR | 2708.52 | 5958.74 | 8847.83 | 10472.94 | 10834.08 | 38822.12 |
| CA | 17335.53 | 38138.16 | 56629.39 | 67030.71 | 69342.11 | 248475.90 |
| CO | 4623.67 | 6736.67 | 10002.93 | 11840.21 | 12248.49 | 45451.97 |
| CT | 4431.22 | 9748.69 | 15922.86 | 19704.17 | 20383.62 | 70190.56 |
| DE | 723.33 | 1591.33 | 2362.89 | 2796.89 | 2893.33 | 10367.77 |
| DC | 369.38 | 812.64 | 1206.65 | 1428.28 | 1477.53 | 5294.48 |
| FL | 8672.09 | 19078.61 | 28328.84 | 33532.10 | 34688.38 | 124300.01 |
| GA | 4286.59 | 9430.49 | 14002.85 | 16574.81 | 17146.35 | 61441.09 |
| HI | 881.63 | 1939.58 | 2879.98 | 3408.95 | 3526.50 | 12636.64 |
| ID | 1207.66 | 2656.86 | 3945.03 | 4669.63 | 4830.65 | 17309.83 |
| IL | 10470.45 | 23034.98 | 34203.45 | 40485.72 | 41881.78 | 150076.38 |
| IN | 6797.40 | 14954.28 | 22204.84 | 26283.28 | 27189.60 | 97429.41 |
| IA | 3932.31 | 8651.08 | 12845.55 | 15204.93 | 15729.24 | 56363.11 |
| KS | 2469.99 | 5433.98 | 8068.64 | 9550.63 | 9879.96 | 35403.20 |
| KY | 4429.82 | 9745.59 | 14470.73 | 17128.62 | 17719.26 | 63494.02 |
| LA | 5266.28 | 11585.81 | 17203.18 | 20362.95 | 21065.12 | 75483.34 |
| ME | 1356.85 | 2985.08 | 4432.39 | 5246.50 | 5427.42 | 19448.24 |
| MD | 6174.54 | 13583.98 | 20170.15 | 23874.87 | 24698.14 | 88501.68 |
| MA | 4285.14 | 9427.31 | 13998.13 | 16569.22 | 17140.57 | 61420.37 |
| MI | 9796.35 | 21551.96 | 32001.40 | 37879.21 | 39185.39 | 140414.31 |
| MN | 5704.97 | 12550.94 | 18636.25 | 22059.24 | 22819.90 | 81771.30 |
| MS | 3734.64 | 8216.22 | 12199.83 | 14440.62 | 14938.57 | 53529.89 |
| MO | 4945.70 | 10880.54 | 16155.96 | 19123.38 | 19782.81 | 70888.39 |
| MT | 1545.49 | 3400.08 | 5048.60 | 5975.89 | 6181.96 | 22152.01 |
| NE | 2639.75 | 5807.46 | 8623.19 | 10207.04 | 10559.01 | 37836.45 |
| NV | 1017.49 | 2238.48 | 3323.80 | 3934.30 | 4069.96 | 14584.04 |
| NH | 996.72 | 2192.78 | 3255.94 | 3853.97 | 3986.87 | 14286.27 |
| NJ | 4617.35 | 10158.18 | 15083.36 | 17853.77 | 18469.42 | 66182.08 |
| NM | 1878.12 | 4131.86 | 6135.19 | 7262.07 | 7512.48 | 26919.72 |
| NY | 7610.88 | 16743.94 | 24862.22 | 29428.75 | 30443.54 | 109089.34 |
| NC | 8083.34 | 17783.34 | 26405.57 | 31255.57 | 32333.35 | 115861.16 |
| ND | 1094.77 | 2408.50 | 3576.25 | 4233.11 | 4379.08 | 15691.72 |
| OH | 9727.14 | 21399.70 | 31775.31 | 37611.60 | 38908.55 | 139422.30 |
| OK | 4909.37 | 10800.62 | 16037.28 | 18982.91 | 19637.49 | 70367.67 |
| OR | 2292.41 | 5043.29 | 7488.53 | 8863.97 | 9169.62 | 32857.82 |
| PA | 9092.32 | 20003.10 | 29701.58 | 35156.97 | 36369.28 | 130323.26 |
| RI | 785.68 | 1728.51 | 2566.57 | 3037.98 | 3142.74 | 11261.47 |
| SC | 3746.90 | 8243.18 | 12239.87 | 14488.01 | 14987.60 | 53705.56 |
| SD | 892.07 | 1962.56 | 2914.10 | 3449.35 | 3568.29 | 12786.37 |
| TN | 7488.53 | 16474.76 | 24462.53 | 28955.65 | 29954.12 | 107335.58 |
| TX | 15696.42 | 34532.12 | 51274.97 | 60692.82 | 62785.67 | 224982.00 |
| UT | 2303.83 | 5068.44 | 7525.86 | 8908.16 | 9215.34 | 33021.63 |
| VT | 565.56 | 1244.23 | 1847.50 | 2186.83 | 2262.24 | 8106.37 |
| VA | 8207.36 | 18056.18 | 26810.70 | 31735.11 | 32829.43 | 117638.78 |
| WA | 5805.58 | 12772.28 | 18964.90 | 22448.24 | 23222.32 | 83213.32 |
| WV | 1442.02 | 3172.44 | 4710.59 | 5575.80 | 5768.07 | 20668.93 |
| WI | 6233.90 | 13714.57 | 20364.06 | 24104.39 | 24935.58 | 89352.50 |
| WY | 517.57 | 1138.66 | 1690.73 | 2001.27 | 2070.28 | 7418.50 |
| TOTAL: | 232264.86 | 507547.28 | 755078.35 | 894622.91 | 925471.98 | 3314985.37 |

Table II

## HIGHWAY TRUST FUND LOSS RESULTING FROM A 10 CENT INCREASE IN THE FED. GAS TAX
(In thousands of dollars)

| STATE | 1988 | 1989 | 1990 | 1991 | 1992 | TOTAL |
|---|---|---|---|---|---|---|
| AL | 3360.77 | 7393.69 | 10978.51 | 12994.97 | 13443.08 | 48171.03 |
| AK | 450.44 | 990.96 | 1471.43 | 1741.69 | 1801.75 | 6456.28 |
| AZ | 2701.89 | 5944.16 | 8826.17 | 10447.31 | 10807.56 | 38727.08 |
| AR | 2102.18 | 4624.81 | 6867.14 | 8128.45 | 8408.74 | 30131.32 |
| CA | 18537.88 | 40783.33 | 60557.07 | 71679.80 | 74151.51 | 265709.59 |
| CO | 2456.64 | 5404.61 | 8025.02 | 9499.00 | 9826.55 | 35211.82 |
| CT | 2157.56 | 4746.64 | 7048.04 | 8342.58 | 8630.25 | 30925.07 |
| DE | 547.17 | 1203.78 | 1787.43 | 2115.73 | 2188.68 | 7842.79 |
| DC | 219.06 | 481.93 | 715.59 | 847.02 | 876.23 | 3139.82 |
| FL | 8639.15 | 19006.14 | 28221.24 | 33404.73 | 34556.62 | 123827.89 |
| GA | 5753.33 | 12657.33 | 18794.22 | 22246.22 | 23013.33 | 82464.45 |
| HI | 463.34 | 1019.34 | 1513.56 | 1791.57 | 1853.34 | 6641.15 |
| ID | 838.72 | 1845.18 | 2739.81 | 3243.04 | 3354.87 | 12021.62 |
| IL | 7612.76 | 16748.06 | 24868.33 | 29435.99 | 30451.02 | 109116.16 |
| IN | 4947.92 | 10885.43 | 16163.22 | 19131.97 | 19791.70 | 70920.25 |
| IA | 2422.27 | 5328.99 | 7912.74 | 9366.10 | 9689.07 | 34719.15 |
| KS | 2196.19 | 4831.63 | 7174.23 | 8491.95 | 8784.77 | 31478.77 |
| KY | 3044.22 | 6697.29 | 9944.47 | 11771.00 | 12176.90 | 43633.88 |
| LA | 3261.78 | 7175.92 | 10655.15 | 12612.21 | 13047.12 | 46752.17 |
| ME | 978.72 | 2153.18 | 3197.14 | 3784.37 | 3914.87 | 14028.28 |
| MD | 3250.16 | 7150.36 | 10617.20 | 12567.30 | 13000.65 | 46585.68 |
| MA | 3725.04 | 8195.08 | 12168.45 | 14403.47 | 14900.14 | 53392.17 |
| MI | 6294.39 | 13847.65 | 20561.67 | 24338.30 | 25177.55 | 90219.56 |
| MN | 3285.75 | 7228.64 | 10733.44 | 12704.89 | 13142.99 | 47095.71 |
| MS | 2228.88 | 4903.54 | 7281.02 | 8618.35 | 8915.53 | 31947.31 |
| MO | 4457.99 | 9807.57 | 14562.76 | 17237.56 | 17831.95 | 63897.83 |
| MT | 793.61 | 1745.94 | 2592.46 | 3068.62 | 3174.44 | 11375.06 |
| NE | 1436.39 | 3160.06 | 4692.21 | 5554.04 | 5745.56 | 20588.25 |
| NV | 878.01 | 1931.63 | 2868.17 | 3394.98 | 3512.05 | 12584.85 |
| NH | 679.54 | 1494.98 | 2219.82 | 2627.54 | 2718.15 | 9740.04 |
| NJ | 5371.02 | 11816.24 | 17545.33 | 20767.95 | 21484.08 | 76984.63 |
| NM | 1335.61 | 2938.34 | 4362.98 | 5164.35 | 5342.43 | 19143.71 |
| NY | 8880.84 | 19537.84 | 29010.74 | 34339.24 | 35523.35 | 127292.01 |
| NC | 5164.27 | 11361.39 | 16869.94 | 19968.50 | 20657.07 | 74021.18 |
| ND | 666.47 | 1466.23 | 2177.13 | 2577.02 | 2665.88 | 9552.73 |
| OH | 8045.59 | 17700.30 | 26282.27 | 31108.63 | 32182.37 | 115320.16 |
| OK | 3199.94 | 7039.87 | 10453.13 | 12373.10 | 12799.76 | 45865.79 |
| OR | 1751.06 | 3852.34 | 5720.14 | 6770.78 | 7004.26 | 25098.59 |
| PA | 7526.20 | 16557.64 | 24585.58 | 29101.30 | 30104.80 | 107875.52 |
| RI | 571.54 | 1257.38 | 1867.02 | 2209.94 | 2286.15 | 8192.04 |
| SC | 2863.15 | 6298.93 | 9352.96 | 11070.88 | 11452.60 | 41038.49 |
| SD | 706.15 | 1553.53 | 2306.76 | 2730.45 | 2824.61 | 10121.51 |
| TN | 4430.22 | 9746.49 | 14472.07 | 17130.20 | 17720.90 | 63499.89 |
| TX | 15581.23 | 34278.70 | 50898.68 | 60247.42 | 62324.92 | 223330.95 |
| UT | 1212.88 | 2668.33 | 3962.06 | 4689.79 | 4851.50 | 17384.55 |
| VT | 420.56 | 925.24 | 1373.84 | 1626.18 | 1682.26 | 6028.09 |
| VA | 4712.99 | 10368.57 | 15395.75 | 18223.54 | 18851.94 | 67552.79 |
| WA | 3147.22 | 6923.88 | 10280.91 | 12169.25 | 12588.87 | 45110.13 |
| WV | 1346.40 | 2962.08 | 4398.24 | 5206.09 | 5385.61 | 19298.42 |
| WI | 3438.15 | 7563.93 | 11231.29 | 13294.17 | 13752.59 | 49280.13 |
| WY | 688.40 | 1514.49 | 2248.79 | 2661.83 | 2753.62 | 9867.13 |
| TOTAL: | 180781.64 | 397719.60 | 590553.35 | 699022.33 | 723126.55 | 2591203.47 |

Sources: Federal Highway Administration; Joint Committee on Taxation, U.S. Congress; American Automobile Association.

## STATE REVENUE LOSS RESULTING FROM INCREASED FEDERAL EXCISE TAX ON CIGARETTES
(In Thousands of Dollars)

| STATE | COLLECTIONS* | FIRST YEAR | | OVER FIVE YEARS | |
|---|---|---|---|---|---|
| | | LOST ST REV .08 TAX INCR | LOST ST REV .16 TAX INCR | LOST ST REV .08 TAX INCR | LOST ST REV .16 TAX INCR |
| AL | 71,199.00 | 2071.244 | 4142.487 | 10356.218 | 20712.436 |
| AK | 8,109.00 | 235.898 | 471.796 | 1179.491 | 2358.982 |
| AZ | 50,005.00 | 1454.691 | 2909.382 | 7273.455 | 14546.909 |
| AR | 59,788.00 | 1739.287 | 3478.575 | 8696.436 | 17392.873 |
| CA | 258,975.00 | 7533.818 | 15067.636 | 37669.091 | 75338.182 |
| CO | 50,929.00 | 1481.571 | 2963.142 | 7407.855 | 14815.709 |
| CT | 88,588.00 | 2577.105 | 5154.211 | 12885.527 | 25771.055 |
| DE | 12,300.00 | 357.818 | 715.636 | 1789.091 | 3578.182 |
| DC | 9,299.00 | 270.516 | 541.033 | 1352.582 | 2705.164 |
| FL | 289,692.00 | 8427.404 | 16854.807 | 42137.018 | 84274.036 |
| GA | 88,580.00 | 2576.873 | 5153.745 | 12884.364 | 25768.727 |
| HI | 17,704.00 | 515.025 | 1030.051 | 2575.127 | 5150.255 |
| ID | 8,412.00 | 244.713 | 489.425 | 1223.564 | 2447.127 |
| IL | 198,964.00 | 5788.044 | 11576.087 | 28940.218 | 57880.436 |
| IN | 76,365.00 | 2221.527 | 4443.055 | 11107.636 | 22215.273 |
| IA | 70,540.00 | 2052.073 | 4104.145 | 10260.364 | 20520.727 |
| KS | 56,514.00 | 1644.044 | 3288.087 | 8220.218 | 16440.436 |
| KY | 18,287.00 | 531.985 | 1063.971 | 2659.927 | 5319.855 |
| LA | 81,696.00 | 2376.611 | 4753.222 | 11883.055 | 23766.109 |
| ME | 37,719.00 | 1097.280 | 2194.560 | 5486.400 | 10972.800 |
| MD | 67,603.00 | 1966.633 | 3933.265 | 9833.164 | 19666.327 |
| MA | 173,263.00 | 5040.378 | 10080.756 | 25201.891 | 50403.782 |
| MI | 239,387.00 | 6963.985 | 13927.971 | 34819.927 | 69639.855 |
| MN | 97,635.00 | 2840.291 | 5680.582 | 14201.455 | 28402.909 |
| MS | 49,540.00 | 1441.164 | 2882.327 | 7205.818 | 14411.636 |
| MO | 81,783.00 | 2379.142 | 4758.284 | 11895.709 | 23791.418 |
| MT | 12,514.00 | 364.044 | 728.087 | 1820.218 | 3640.436 |
| NE | 30,872.00 | 898.095 | 1796.189 | 4490.473 | 8980.945 |
| NV | 19,488.00 | 566.924 | 1133.847 | 2834.618 | 5669.236 |
| NH | 32,859.00 | 955.898 | 1911.796 | 4779.491 | 9558.982 |
| NJ | 215,905.00 | 6280.873 | 12561.745 | 31404.364 | 62808.727 |
| NM | 14,804.00 | 430.662 | 861.324 | 2153.309 | 4306.618 |
| NY | 424,096.00 | 12337.338 | 24674.676 | 61686.691 | 123373.382 |
| NC | 16,515.00 | 480.436 | 960.873 | 2402.182 | 4804.364 |
| ND | 11,694.00 | 340.189 | 680.378 | 1700.945 | 3401.891 |
| OH | 183,849.00 | 5348.335 | 10696.669 | 26741.673 | 53483.345 |
| OK | 68,183.00 | 1983.505 | 3967.011 | 9917.527 | 19835.055 |
| OR | 74,346.00 | 2162.793 | 4325.585 | 10813.964 | 21627.927 |
| PA | 238,100.00 | 6926.545 | 13853.091 | 34632.727 | 69265.455 |
| RI | 30,517.00 | 887.767 | 1775.535 | 4438.836 | 8877.673 |
| SC | 28,073.00 | 816.669 | 1633.338 | 4083.345 | 8166.691 |
| SD | 14,738.00 | 428.742 | 857.484 | 2143.709 | 4287.418 |
| TN | 77,972.00 | 2268.276 | 4536.553 | 11341.382 | 22682.764 |
| TX | 358,783.00 | 10437.324 | 20874.647 | 52186.618 | 104373.236 |
| UT | 12,403.00 | 360.815 | 721.629 | 1804.073 | 3608.145 |
| VT | 11,610.00 | 337.745 | 675.491 | 1688.727 | 3377.455 |
| VA | 17,238.00 | 501.469 | 1002.938 | 2507.345 | 5014.691 |
| WA | 103,011.00 | 2996.684 | 5993.367 | 14983.418 | 29966.836 |
| WV | 35,422.00 | 1030.458 | 2060.916 | 5152.291 | 10304.582 |
| WI | 121,428.00 | 3532.451 | 7064.902 | 17662.255 | 35324.509 |
| WY | 4,766.00 | 138.647 | 277.295 | 693.236 | 1386.473 |
| TOTAL: | 4,422,082.00 | 128,641.80 | 257,283.61 | 643209.018 | 1286418.036 |

*COLLECTIONS represents net cigarette tax collections for period ending June 30, 1986

## STATE REVENUE LOSS RESULTING FROM INCREASED FEDERAL EXCISE TAX ON ALCOHOLIC BEVERAGES

(In Thousands of Dollars)

| STATE | DISTILLED ($2.00/gal.) | WINE ($.52/5th) | BEER ($.49/6 pk) | TOTAL |
|---|---|---|---|---|
| AL | 2243.184 | 435.700 | 2095.350 | 4774.234 |
| AK | 246.344 | 81.000 | 234.181 | 561.525 |
| AZ | 1065.680 | 740.300 | 2031.078 | 3837.058 |
| AR | 493.679 | 110.400 | 818.479 | 1422.558 |
| CA | 6208.196 | 3708.350 | 7321.858 | 17238.404 |
| CO | 858.992 | 427.350 | 1124.842 | 2411.185 |
| CT | 1624.772 | 871.450 | 1659.165 | 4155.388 |
| DE | 117.018 | 32.350 | 45.979 | 195.347 |
| DC | 611.958 | 339.700 | 491.063 | 1442.721 |
| FL | 6716.465 | 4253.350 | 11161.739 | 22131.554 |
| GA | 1716.574 | 932.300 | 3453.796 | 6102.670 |
| HI | 162.168 | 113.750 | 457.114 | 733.032 |
| ID | 313.349 | 307.350 | 405.326 | 1026.024 |
| IL | 3031.360 | 1331.900 | 4615.512 | 8978.772 |
| IN | 1266.814 | 464.200 | 2327.965 | 4058.979 |
| IA | 1401.394 | 530.650 | 1151.128 | 3083.172 |
| KS | 600.490 | 178.250 | 1020.400 | 1799.140 |
| KY | 703.188 | 205.250 | 1238.760 | 2147.199 |
| LA | 1182.398 | 374.450 | 2863.070 | 4419.918 |
| ME | 748.729 | 179.500 | 683.879 | 1612.108 |
| MD | 1060.727 | 495.050 | 1481.634 | 3037.411 |
| MA | 2061.143 | 745.350 | 1195.212 | 4001.705 |
| MI | 4140.418 | 968.200 | 3807.828 | 8916.446 |
| MN | 2305.656 | 667.100 | 2743.673 | 5716.429 |
| MS | 1210.468 | 252.300 | 1751.906 | 3214.673 |
| MO | 909.666 | 393.450 | 1689.694 | 2992.810 |
| MT | 406.801 | 127.550 | 143.335 | 677.686 |
| NE | 300.800 | 120.650 | 563.904 | 985.355 |
| NV | 474.976 | 227.650 | 433.795 | 1136.421 |
| NH | 754.072 | 282.750 | 465.272 | 1502.094 |
| NJ | 2336.877 | 1107.950 | 1791.953 | 5236.780 |
| NM | 339.046 | 201.700 | 749.922 | 1290.668 |
| NY | 7133.262 | 1794.250 | 4096.228 | 13023.740 |
| NC | 2698.108 | 995.950 | 3442.960 | 7137.018 |
| ND | 194.349 | 47.550 | 309.824 | 551.723 |
| OH | 4143.991 | 1035.800 | 5535.261 | 10715.052 |
| OK | 744.766 | 179.000 | 1094.396 | 2018.162 |
| OR | 1652.031 | 319.950 | 241.597 | 2213.577 |
| PA | 5068.217 | 2391.050 | 3089.464 | 10548.731 |
| RI | 332.562 | 194.350 | 457.158 | 984.067 |
| SC | 1760.493 | 448.000 | 3080.153 | 5288.646 |
| SD | 234.186 | 67.400 | 319.176 | 620.762 |
| TN | 1686.764 | 580.900 | 1561.974 | 3829.638 |
| TX | 4020.128 | 1750.600 | 12099.080 | 17869.809 |
| UT | 737.501 | 314.350 | 649.436 | 1701.287 |
| VT | 348.832 | 80.550 | 233.480 | 662.863 |
| VA | 2753.915 | 1087.100 | 2468.416 | 6309.430 |
| WA | 4273.407 | 1466.700 | 1739.093 | 7479.200 |
| WV | 587.101 | 103.750 | 797.756 | 1488.607 |
| WI | 1612.254 | 390.600 | 2046.981 | 4049.835 |
| WY | 196.751 | 70.250 | 173.081 | 440.082 |
| TOTAL: | 87792.019 | 34525.350 | 105454.325 | 227771.694 |

# STATEMENT OF THE
# NATIONAL NEWSPAPER ASSOCIATION
# AND THE
# NATIONAL NEWSPAPER PUBLISHERS ASSOCIATION
# BEFORE
# THE FINANCE COMMITTEE OF
# THE UNITED STATES SENATE
# CONCERNING PROPOSALS
# TO ALTER THE TAX TREATMENT OF THE
# BUSINESS DEDUCTION FOR ADVERTISING EXPENSES

JULY 27, 1987

## INTRODUCTION

The National Newspaper Association (NNA) is a national trade association that represents the interests of daily and weekly newspapers throughout the country. Founded in 1885, and with over 5,000 member newspapers, NNA is the oldest and largest trade association in the newspaper industry.

The National Newspaper Publishers Association (NNPA) is a national trade association representing the interests of the major black owned daily and weekly newspapers in the country. It was founded in 1940 and currently has 150 members.

NNA and NNPA oppose any revenue-raising option which would deny either in total or in part, a tax deduction for legitimate advertising expenditures as an ordinary business expense. NNA and NNPA also oppose any option which would treat advertising as a depreciable asset, for such an option is based on the flawed assumption that all advertising has a life beyond one year. Either of these approaches single out advertising expenses from other legitimate business expenses, heavily penalizing the retail sector of the economy. Further, the task of defining, in a principled fashion which is consistent with traditional tax policy, exactly what is and is not "advertising" is no simple task.

Finally, any government action to make advertising more expensive for businesses likely will result in reduced advertising. Because advertising is designed to inform the consumer of the availability of goods and services in a timely manner, a reduction in advertising would likely lead to reduced product sales. Reduced product sales could in turn lead to downturns in local economies--particularly those which are currently depressed-- and could have a negative impact on employment. Any limitation on advertising deductibility would particularly burden the newspaper industry which receives 70 percent or more of its total revenue from advertising.

## ADVERTISING AS A COST OF DOING BUSINESS

Section 162 of title 26 of the United States Code provides for the full deductibility of ordinary business-related expenses. By doing so, the section implements the net income concept of this country's tax system.

For over 70 years the federal government has taxed profits, not gross income, in recognition of the principle that the portion of gross income equal to the cost of earning that income should not be taxed. To break that principle and start denying deductions for particular types of expenses which are necessarily incurred in the ordinary course of doing business makes no sense.

Advertising expenses are no different than other marketing expenses or manufacturing expenses. Advertising is just as necessary and legitimate as other marketing expenses or as any manufacturing expense. To single out advertising expenses is to discriminate, without any rational basis, against advertising and the industries which depend upon it.

## NEWSPAPER ADVERTISING IS A CURRENT EXPENSE AND NOT AN ASSET

Forcing all or part of newspaper advertising costs to be amortized rather than deducted likewise makes no sense. Most newspaper advertising, because of the nature of the retail and service industries, is immediate. It has no residual effect beyond the scope of the immediate future, which is certainly less than a year.[1/]

The proposal to amortize advertising is based on a suggestion that some benefit of advertising carries over beyond the year in which the expenses are incurred. The overwhelming volume of newspaper advertising is designed to alert the consumer to the availability of a certain product or service, at a certain price, under certain conditions, and often at a specific location. Newspaper advertisements are not placed to build a product image. There is little, if any, residual impact from the kind of retail/price/service advertising which is the predominant revenue source of local newspapers.

Readers use the newspaper as a daily catalogue of merchandise, services, comparative prices, sales and style information. Successful newspaper advertisements reflect a similar sense of immediacy as that which exists in the news columns. The job hunter searches the classified advertisements with the hope and intention of finding a job, and finding it now. Likewise, the reader in the market for a new suit will study the newspaper advertisements to get ideas on the specifics of style and pricing before going shopping, and going shopping now. Grocery, automobile, drug store, and even bank rate advertising are aimed at comparison shoppers. Readers will check for the latest sales and best deals available at each point in time.

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[1/] And in most cases less than a week or two, often only a day or two.

Take the following situations where advertising is clearly intended for an immediate impact, and where it would be unfair and inaccurate to limit ad deductions based on the notion that there is a benefit extending beyond one year:

> --Announcements of a special sale which will last only a day or two (Fathers' Day Sale, Valentine's Day Sale, Christmas sales, etc.).
>
> --Classified advertising proposing the sale of new or used goods, such as automobiles, which are rendered useless after the sale or transaction takes place, even though the ad may still have a day or two to run.
>
> --Real estate advertising.
>
> --Airline advertising announcing the best price to the West Coast.
>
> --Advertising for snow tires placed immediately after the first snow, or advertising for air conditioners or fans placed in Washington D. C. newspapers immediately after the first wave of heat and humidity.

There are thousands of parallel examples.

In each of these cases, the benefits from advertising are realized only in the short term. Yet the options before the Senate Finance Committee seem to assume that because it is impossible to measure the exact lasting power of advertising, the government should arbitrarily assign a particular length to be applied uniformly across all forms of advertising.

It is important to distinguish the reputation or good-will generated by a product or a service from the advertising of that product or service. Newspaper advertising conveys information to consumers about products and services available; but it cannot create the good-will that results only from product or service quality. It is the quality of the product or service delivered that ultimately creates a reputation among consumers. It is inaccurate to ascribe long term good will to newspaper advertising as a basis for delaying tax deductions beyond one year.

## THE PROBLEMS OF DEFINING ADVERTISING

A fundamental problem with the proposal to limit the deductibility of advertising expenses is how to define what will or will not be considered "advertising." Advertising is a marketing concept, part of the overall marketing/sales process. Thus, the problem arises in trying to distinguish between advertising and promotional expenses on the one hand and fully deductible selling expenses on the other.

The IRS would be forced to try to draw the lines which rule one type of marketing expense "advertising" and another not. Much of the advertising activities of a business, however, would fall into gray areas in which precise definitions would be extremely difficult and extremely technical to make. For example, would the salary of a marketing director be divided between advertising and non-advertising activities, some fully deductible and the rest only partially so? What about the salaries for trainees? Are public relations and research and development costs part of advertising expenses, marketing expenses or both? What about salaries and other expenses associated with commercial art departments?

There are many other expenses which would fall somewhere among advertising costs, marketing costs, and normal business operating costs. For example, is an ad in the local Yellow Pages really advertising or is it considered an "ordinary and necessary expense" incurred by most businesses? What about building signs, office signs, business cards and white pages entries? These are expenses incurred by any business whether they actually advertise their product or simply process raw materials for use by someone else. For the raw materials manufacturer, those costs may not be considered advertising, but for those whose business cards may reinforce a particular brand name or company, they may very well be part of the advertising costs.

What about retail business which, in order to draw customers into their stores, conduct free drawings to give away prizes such as automobiles? Would the price of the prize be considered an advertising expense?

## EFFECT ON NEWSPAPERS

As a result of a decreased ability to deduct advertising expenses, retail advertisers would have fewer after-tax dollars available to spend on advertising. They would therefore decrease their advertising linage rather than attempt to absorb the increased tax burden themselves. As a result, the number of advertisements placed would decrease, as would a newspaper's revenue base, in some cases significantly.

NNA and NNPA estimate that 70 percent or more of a newspaper's total revenue comes from advertising, most from retail and service industries, and that the figure is perhaps as much as 80 or 90 percent for weeklies. All newspapers depend primarily on local retail advertisers, and newspapers with reduced advertising revenues are forced to cut costs through smaller news staffs and smaller news holes. The most vulnerable newspapers would the marginal ones in highly competitive markets, and dailies and weeklies publishing in communities with already depressed economic conditions.

In many cases rural papers are the only source of news and other local information in the communities they serve. If these papers are forced out of business or forced to significantly reduce their service, the citizens of their communities would suffer. They would be left with a reduced or without any regular and dependable source of local information.

Thank you for considering our views.

# TESTIMONY OF
# BILL BALDEN
# ON BEHALF OF THE
# NATIONAL TOBACCO COUNCIL
# BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman and distinguished members of the Committee, my name is Bill Balden, and I am President of the National Tobacco Council. The council represents the interests of a wide range of businesses involved in the growing, processing, manufacturing, wholesaling and retailing of tobacco and tobacco products. I appreciate this opportunity to express the council's views on proposed increases in the federal excise tax on cigarettes.

The council appreciates the need to raise revenues to reduce the deficit. But selective increases in excise taxes are not the answer. These taxes are widely acknowledged to be fiscally unsound, regressive and damaging to industry and to the economy as a whole.

Excise taxes are unfair and discriminatory. They single out certain consumers and industries to bear a disproportionate tax burden. Tobacco smokers are no more responsible than other citizens for the swelling federal deficit; there is no justification for imposing a greater tax burden on them.

For more than a century, smokers have paid more taxes than non-smokers -- $200 billion more taxes in all. In addition to the federal tax of 16 cents per pack on cigarettes, each state and 388 localities impose some form of excise tax on tobacco products. The average state and local tax is 22 cents per pack. Combined with the federal tax, the average total tax on tobacco products is 38 cents per pack. Last year, smokers paid nearly $10 billion in excise taxes to federal, state and local tax collectors. In other words, Mr. Chairman, smokers already are paying their fair share and then some.

In addition, because excise taxes are "regressive" in nature, they penalize those least able to pay. Based on a percentage of income, people in the lowest income bracket pay 15-to-27 times more in excise taxes than people in the highest income level.

Moreover, a recent study by the Congressional Budget Office concluded that, of all the excise tax increases being considered, the tax on cigarettes is the most regressive. The burden of cigarette excises is more than five times greater on low-income families than on those with incomes above $50,000.

Excise taxes are bad fiscal policy. These taxes have a negative effect on the economy, impacting producers, wholesalers and distributors, and creating a ripple effect in communities across the United States. They reduce consumer spending power, limit capital investment, slow growth of the economy and encourage unemployment.

By any measure tobacco is a major contributor to the economy of the United States. The tobacco industry generates $82 billion per year toward the Gross National Product -- that's 2.5% of the GNP. It also generates $8 billion per year in federal tax revenues, more than half of that in excise taxes.

The "core tobacco industry" -- which includes everything from growing to retailing -- employs more than 400,000 people. For every core industry job, three more are created in supplier industries, such as fertilizer, transportation and warehousing.

All told, according to a study by Chase Econometrics, the tobacco industry directly or indirectly creates or supports 2.3 million jobs in this country.

Excise tax rate increases lead to a decline in demand and therefore revenue, output, earnings and employment in the cigarette industry and each of its supporting sectors. Experts estimate that a four-cent increase in the cigarette tax would cost nearly 7,000 jobs in the core industry alone; a 16-cent increase would throw 27,000 core industry employees out of work.

A great many economists agree that excise taxes are poor economic policy. For example, David Raboy, director of research for the Institute for Research on the Economics of Taxation, states that "selective excises should not be employed merely to raise revenues. These taxes are distortionary and...would be a giant step backwards." Experts criticize excise taxes for their artificial manipulation of the marketplace, their drain on capital and their regressive and arbitrary nature.

Mr. Chairman, 200 years ago Alexander Hamilton warned that taxes on specific items would lead to "the oppression of particular branches of industry." One particularly onerous tax led to a tea party in Boston Harbor, and helped spur the American Revolution. The National Tobacco Council urges you to reject any further increase in taxes paid by the tobacco industry, its employees and customers nationwide. Thank you.

# Testimony of Elton Jolly
Opportunities Industrialization Centers of America
Submitted to the
Committee on Finance
United States Senate
August 11, 1987

My name is Elton Jolly, and I am President and Chief Executive Officer of Opportunities Industrialization Centers of America (OIC). OIC of America is a network of comprehensive, non-profit training and employment placement programs throughout the country serving the economically disadvantaged, unskilled and underskilled persons in America.

I appreciate the opportunity to testify before the committee, and am confident that many committee members share the spirit of OIC's mission. I am concerned, however, that some of the proposals before us today would hinder those whom OICs work so hard to help, and the ability of economically disadvantaged Americans to stand on their own.

I am speaking about proposals to increase excise taxes on everyday items -- from gasoline to telephone service, cigarettes to beer. This type of taxation aggravates poverty and unemployment. They impede the progress of people eager for opportunities to work, to advance themselves and to realize relatively small dreams, but who, for lack of money and skills are trapped in the circle of poverty.

The committee recognized this when, as part of the historic Tax Reform Act of 1986, removed individuals who earned below $4500 (individual return) from the tax rolls. That helped my constituency -- such as high school drop-outs, single mothers, displaced workers, and particularly youth, -- take a step forward. It allowed these people to stop worrying about their income tax burden until they became productive citizens, able to pay.

Now, after this important step toward tax fairness and equity, some in Congress wish to repudiate their historic accomplishment by increasing excise taxes on several basic necessities and everyday items.

Excise taxes are regressive, increasing in relative magnitude as income decreases. They are a thinly disguised attempt to raise taxes at the expense of consumers who are least able to afford them. They increase the price of everyday goods, increase the costs of doing business, decrease business profits, lower workers' wages, and encourage unemployment. They take a disproportionately large bite out of the budgets of low-income families.

Recent reports by independent organizations -- and by the Congressional Budget Office -- document the regressive effects of excise taxes. As a percentage of income, the difference in the impact of excise taxes on low-income families and high-income families is as high as 25 times or more.

And, as I mentioned, excise tax increases could wipe out the gains made by low-income people in last year's Tax Reform Act. According to a report by Citizens for Tax Justice, a major package of excise tax hikes would cost the poor more than double what they gained in income tax cuts, while the wealthy would walk away with most of their 1986 cuts intact.

Significantly, excise taxes also are discriminatory, placing an unfair burden on minorities. Blacks, Hispanics, youth, single mothers and others have disproportionately high levels of poverty and unemployment. Increases in excise taxes, therefore, affect these groups much more than others.

In short, excise taxes drain money from the already economically disadvantaged individuals we work with at OICs, and from the businesses that we need to create job opportunities for those people. During its more than 20 years, OICs have served over 970,000 persons; more than 724,000 received training and 75% of them are now employed. About one-third of our trainees were on welfare before coming to us. The federal government cannot afford tax policy that aggravates poverty and discourages individuals from becoming self-sufficient and productive workers. I urge you to reject increases in excise taxes.

Thank you.

## STATEMENT OF ROBERT J. SCOTT

## ON BEHALF OF

## ORGANIZATION FOR THE PRESERVATION OF THE PUBLIC EMPLOYEES' RETIREMENT INDUSTRY AND OPPOSITION TO SOCIAL SECURITY EXPANSION TO SUCH INDUSTRY

## (OPPOSE)

Members of the House Committee on Ways and Means, I am Robert J. Scott, secretary-treasurer of OPPOSE. OPPOSE is a Colorado corporation formed by teachers, firefighters, police, and other state and local government employees who have elected not to join the Social Security system. The purpose of our organization is to assure the continued financial integrity of our members' retirement and health insurance plans by resisting congressional efforts to mandate Social Security or Medicare coverage of public employees. Our members are found in Alaska, California, Colorado, Illinois, Louisiana, Massachusetts, Nevada, and Ohio. With respect to the issue of mandatory Medicare coverage, the interests of OPPOSE are identical to those of the four to five million public employees throughout the nation who remain outside the Social Security system.

Through this testimony, we wish to express our strong opposition to the proposal in the Administration's budget to impose Medicare coverage upon all state and local government employees effective January 1, 1988.

By way of background, I would remind you that employees of state and local government were not permitted to join the Social Security system when it was established in 1935. While they have been permitted to join since the 1950s, those who have chosen to remain outside the system have their own retirement plans and, in many instances, health insurance plans.

In response to the federal government's pressing need for revenues, Congress, in the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), determined to require public employers and their employees to pay the Medicare tax. It implemented this decision by extending mandatory Medicare coverage to all state and local government employees hired on or after April 1, 1986. Through adoption of this phase-in provision, which will result in Medicare coverage of all public employees through normal job turnover, Congress assured itself that all public employees will ultimately pay the full Medicare tax to the federal government. The individuals excluded from coverage under COBRA were those who were already working and for whom the Medicare tax would both constitute a pay cut and jeopardize their existing health benefits. While we at OPPOSE did not favor mandatory Medicare coverage, we believed that the phase-in provision adopted in COBRA was a reasonable, permanent solution that avoided imposing overwhelming burdens on state and local governments and their employees.

Last year, during consideration of the Omnibus Budget Reconciliation Act of 1986, Congress threatened to abandon COBRA's phase-in by mandating coverage of those employees specifically excluded from coverage under COBRA, but, in the end, did not adopt such a provision.

We believe that the phase-in compromise reached in COBRA should be respected and that our employees and retirees should not be visited by the same threat year in and year out. Therefore, and for the reasons set forth below, OPPOSE asks you this year once and for all to reject the proposal to extend mandatory Medicare coverage to all state and local government employees.

1. Despite the promises of the President not to raise taxes and the avowed intentions of many legislators to provide a tax cut to the middle class, this proposal targets four to five million lower-middle-class Americans and their spouses for a tax increase that would more than offset the tax cut that they will receive as a result of the Tax Reform Act of 1986. According to estimates of the Joint Committee on Taxation, the Tax Reform Act would provide taxpayers with incomes in the range of $20,000 - $30,000 with a cut equivalent on the average to $220. The new Medicare tax that would be imposed upon state and local government employees equals 1.45% of payroll. Thus, in the case of the average government employee in Colorado (whose annual salary is $23,676), the new Medicare tax of $343 would result in a net tax increase of $123. If the Colorado government passes its equivalent new tax along to its employees, the average employee's tax increase could double.

2. Mandatory Medicare coverage would impose a heavy fiscal burden upon state and local governments, which are already operating with very limited resources. While the impact of the proposal would fall most heavily upon governments in approximately ten states, almost every state includes some subdivisions with non-covered employees that would be significantly harmed by these additional operating costs. (See attached table.) We would point out that the proposal would cost governments in Texas $162 million in the first year; governments in Hawaii, $8 million; governments in Colorado, $50 million; and governments in New York, $51 million.

Imposition of these additional costs would come at a particularly trying time. State and local governments have repeatedly been forced to shoulder additional burdens in recent years, resulting from considerable cuts in the federal appropriations for many of their programs and the loss of revenue-sharing, while the Tax Reform Act limited their ability to raise revenues, through loss of the sales tax deduction and new restrictions upon municipal bonds.

As a result, state and local governments (many of which operate under balanced budget restrictions) are simply unable to absorb additional fiscal burdens. Many local governments must already raise taxes to maintain existing public service spending levels formerly funded through revenue-sharing. A recent study by the National League of Cities concluded that general fund revenues will decline this year for one-third of the cities and towns throughout the United States.

3. Mandatory Medicare coverage would have a pointedly adverse impact upon education. It is well recognized that one of the causes of the current state of our public education system is the extreme difficulty school systems face in recruiting and retaining quality teachers. It has been reported that half of the nation's public school teachers will cease to teach over the next six years and that the country will have 34% fewer teachers than it needs by 1992.

One reason for this problem is that teachers are vastly underpaid. In 1985-1986 the average teacher's salary was $25,000, while the averages ranged state-by-state between $18,000 and $41,000. In constant dollars, the average American schoolteacher's salary has risen only 2.87% over the last ten years. The constant-dollar increase has been even less in several of the states that would be most heavily affected by mandatory coverage. In four of those states (California, Illinois, Louisiana, and Maine) the average teacher's salary has actually declined in constant-dollar terms.

Medicare coverage would only make the teacher recruitment problem worse. Teaching is one of the major professions with large numbers of non-covered employees. The 1.45 percent Medicare tax would take an additional $367 from the average teacher's salary each year. That amount could double if school systems attempt to recoup their own, equal Medicare tax obligations from their employees. Thus, it would become even more difficult to retain good teachers, and many of the most qualified teachers -- particularly those with marketable skills in mathematics, science, and computers -- would simply leave teaching for better paid employment.

4. The mandatory Medicare coverage proposal would create a host of problems that were avoided by the compromise position

adopted in COBRA. As mentioned earlier, some state and local government employees have health plans in place for their employees, including retirees. Adjustment of these plans to take account of Medicare coverage for existing employees would prove an overwhelming task, or would result in abandonment of these plans. For example, Colorado's Public Employees' Retirement Association administers a health insurance plan for its members. Of the overall retirement contribution, 0.8 percent is earmarked for the health insurance fund. If the current mandatory Medicare coverage proposal is adopted, the Colorado legislature (which is already operating under strict budgetary constraints) might well decide to contribute less or none at all to the health insurance plan. Because the benefits of current retirees depend upon current and future contributions, their benefits would certainly be jeopardized. Moreover, as a result of this increased Medicare tax liability, the Colorado legislature might well decide it could not afford cost-of-living adjustments to the retirement benefits of its pensioners.

Unlike COBRA, the current proposal would have the effect of reducing the salaries of existing workers, including long-term employees. This will cause difficulties both for employers and employees, particularly where salaries are carefully negotiated, for example, through the collective bargaining process.

While COBRA affects the health benefits and take-home pay of individuals at the time they begin employment, the effect of the current proposal would be to supplant benefit programs that individuals have enjoyed, in some cases, for many years, and to reduce the amount of take-home pay they have come to expect.

5. The projected revenues for mandatory Medicare coverage are overstated in the Administration's budget and in the re-estimates performed by the Congressional Budget Office. The Administration's budget states that its mandatory Medicare coverage proposal would raise $1.6 billion in fiscal 1988 and $2.2 billion in each of the four following years, while CBO concluded that the proposal would raise $1.3 billion in 1988 and amounts rising from $1.9 billion in 1989 to $2.1 billion in 1992. Since these estimates do not decline in the out-years, they apparently ignore the effect of the provision in COBRA that imposed mandatory Medicare coverage on all newly hired public employees. As a result of that provision, the proportion of Medicare-covered employees in the public work force is increasing rapidly. In Colorado, which we believe to be a typical example, state and local government work forces turn over at a rate of approximately 9% annually. Thus 9% of the work force not covered before COBRA will already be covered by Medicare on April 1, 1987, and approximately 15% will be

covered by January 1, 1988, the effective date of the current mandatory coverage proposal.

Revenues raised by coverage of these new employees have already been obtained by Congress in COBRA and presumably scored for budget purposes. Even if there is some job "turnover within the turnover" as new employees replace those hired after April 1, 1986, the revenues available in the out-years must decline substantially, and ultimately decline to zero, as a result of the complete turnover of the work force. At best, the current mandatory Medicare coverage proposal would provide only "quick fix" deficit reduction and would do nothing to reduce the structural deficit.

Moreover, expansion of mandatory Medicare coverage would also entail offsetting costs to the Medicare system because the newly covered individuals will also become newly entitled to benefits. Some of these cost increases would occur in the very near term because if Congress extends the Medicare tax to all state and local government employees, it will probably provide benefits to those workers who are within five years of retirement (as it did for federal workers when it brought them into the system). While it is frequently asserted that requiring state and local government employees to participate in the Medicare system would be cost-free because the employees already receive Medicare benefits through other covered employment or through their spouses, the number of such employees has been the subject of some dispute and speculation. As a result, the additional costs to the federal government, which must be offset against revenues, may be understated. Given the short-run deficit that now faces the Medicare system, a proposal that involves potential and unpredictable short-term cost increases to the system seems poor policy. Of course, because they span only a few years, the revenue estimate in the President's budget and as re-estimated by CBO fail to reflect any of the long-term costs to the system resulting from the fact that a new class of workers would become entitled to benefits.

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For these reasons, we urge you once again and finally to reject the proposal to extend mandatory Medicare coverage to include all state and local government workers. Thank you for allowing me this opportunity to present the views of OPPOSE.

TABLE

### ANNUAL COST TO STATE AND LOCAL GOVERNMENTS OF MEDICARE COVERAGE OF ALL EMPLOYEES (in millions of dollars) 1/

| State | Number of public employees who are not covered by the Medicare/Social Security system 2/ | Percentage of non-covered public employees 2/ | Cost of coverage of all state and and local employees 3/ |
|---|---|---|---|
| Alabama | 27,000 | 11 | 9.0 |
| Alaska | 40,000 | 69 | 13.3 |
| Arizona | 21,000 | 11 | 7.0 |
| Arkansas | 39,000 | 13 | 13.0 |
| California | 991,000 | 63 | 330.5 |
| Colorado | 150,000 | 76 | 50.0 |
| Connecticut | 63,000 | 37 | 21.0 |
| Delaware | 14,000 | 34 | 4.7 |
| Florida | 127,000 | 21 | 42.3 |
| Georgia | 64,000 | 18 | 21.3 |
| Hawaii | 24,000 | 33 | 8.0 |
| Idaho | 0 | 0 | 0 |
| Illinois | 299,000 | 48 | 99.7 |
| Indiana | 54,000 | 17 | 18.0 |
| Iowa | 5,000 | 2 | 1.7 |
| Kansas | 2,000 | 1 | .7 |
| Kentucky | 56,000 | 27 | 18.7 |
| Louisiana | 271,000 | 85 | 90.4 |
| Maine | 52,000 | 71 | 17.3 |
| Maryland | 29,000 | 10 | 9.7 |
| Massachusetts | 334,000 | 100 | 111.4 |
| Michigan | 19,000 | 4 | 6.3 |
| Minnesota | 96,000 | 33 | 32.0 |
| Mississippi | 2,000 | 1 | .7 |
| Missouri | 62,000 | 22 | 20.7 |
| Montana | 5,000 | 9 | 1.7 |
| Nebraska | 2,000 | 2 | .7 |
| Nevada | 49,000 | 94 | 16.3 |
| New Hampshire | 6,000 | 10 | 2.0 |
| New Jersey | 30,000 | 6 | 10.0 |
| New Mexico | 33,000 | 27 | 11.0 |
| New York | 153,000 | 12 | 51.0 |
| North Carolina | 43,000 | 11 | 14.3 |
| North Dakota | 6,000 | 10 | 2.0 |
| Ohio | 595,000 | 100 | 200.1 |
| Oklahoma | 33,000 | 15 | 11.0 |
| Oregon | 14,000 | 7 | 4.7 |
| Pennsylvania | 36,000 | 6 | 12.0 |
| Rhode Island | 25,000 | 43 | 8.3 |
| South Carolina | 6,000 | 3 | 2.0 |
| South Dakota | 2,000 | 5 | .7 |
| Tennessee | 29,000 | 12 | 9.7 |
| Texas | 486,000 | 50 | 162.0 |
| Utah | 1,000 | 1 | .3 |
| Vermont | 1,000 | 2 | .3 |
| Virginia | 72,000 | 18 | 24.0 |
| Washington | 36,000 | 13 | 12.0 |
| West Virginia | 7,000 | 6 | 2.3 |
| Wisconsin | 48,000 | 16 | 16.0 |
| Wyoming | 5,000 | 10 | 1.7 |
| TOTAL | 4,546,000 | | $1,516.1 |

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1/ These figures reflect only the 1.45% that must be paid by the governments as employers. For the impact of the proposal upon individual employers, who must also begin to pay the 1.45% Medicare tax, see the reverse side.

2/ Social Security Administration, 1985 Current Population Survey and Continuous Work History Sample, reprinted in Congressional Research Service paper "Medicare Coverage of Employees of State and Local Government," prepared at the request of the Subcommittee on Health of the House Committee on Ways and Means by David Koitz, Specialist in Social Legislation, Education and Public Welfare Division (March 11, 1987). Presumably included in these estimates are jobs now filled by employees hired after March 31, 1986, who participate in the Medicare system as a result of the Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. 99-272. These figures might therefore be reduced marginally to account for employee turnover (estimated to occur at a rate of approximately 9% annually) since March 31, 1986.

3/ Given that the employer's part of the 1987 Medicare tax is 1.45%, and assuming that the salary of the average state or local government employee is $23,000, each governmental employer's cost is equal to the number of employees, multiplied by 23,000, multiplied by 1.45%.

## ANNUAL COST TO STATE AND LOCAL GOVERNMENT EMPLOYERS OF MEDICARE COVERAGE OF ALL EMPLOYEES

| State | Annual salary of average public Employee 1/ | Annual tax increase resulting from proposal 2/ | Average tax decrease resulting from the Tax Reform Act 3/ |
|---|---|---|---|
| Alabama | $19,272 | $279 | $200 |
| Alaska | 39,084 | 567 | 273 |
| Arizona | 24,996 | 362 | 220 |
| Arkansas | 17,796 | 258 | 200 |
| California | 30,084 | 436 | 273 |
| Colorado | 23,676 | 343 | 220 |
| Connecticut | 24,360 | 353 | 220 |
| Delaware | 22,884 | 332 | 220 |
| Dist. of Columbia | 33,288 | 483 | 273 |
| Florida | 20,556 | 298 | 220 |
| Georgia | 19,056 | 276 | 200 |
| Hawaii | 22,596 | 328 | 220 |
| Idaho | 18,852 | 273 | 200 |
| Illinois | 24,780 | 359 | 220 |
| Indiana | 22,560 | 327 | 220 |
| Iowa | 21,024 | 305 | 220 |
| Kansas | 20,124 | 292 | 220 |
| Kentucky | 19,248 | 279 | 200 |
| Louisiana | 19,080 | 277 | 200 |
| Maine | 18,444 | 267 | 200 |
| Maryland | 27,144 | 394 | 220 |
| Massachusetts | 23,976 | 348 | 220 |
| Michigan | 26,808. | 389 | 220 |
| Minnesota | 25,296 | 367 | 220 |
| Mississippi | 16,116 | 234 | 200 |
| Missouri | 20,244 | 294 | 220 |
| Montana | 22,284 | 323 | 220 |
| Nebraska | 18,588 | 270 | 200 |
| Nevada | 23,676 | 343 | 220 |
| New Hampshire | 19,308 | 280 | 200 |
| New Jersey | 24,192 | 351 | 220 |
| New Mexico | 19,608 | 284 | 200 |
| New York | 26,220 | 380 | 220 |
| North Carolina | 19,956 | 289 | 200 |
| North Dakota | 21,984 | 319 | 220 |
| Ohio | 21,492 | 312 | 220 |
| Oklahoma | 18,816 | 273 | 200 |
| Oregon | 22,632 | 328 | 220 |
| Pennsylvania | 22,068 | 320 | 220 |
| Rhode Island | 24,204 | 351 | 220 |
| South Carolina | 18,120 | 263 | 200 |
| South Dakota | 17,232 | 250 | 200 |
| Tennessee | 18,588 | 270 | 200 |
| Texas | 20,676 | 300 | 220 |
| Utah | 21,528 | 312 | 220 |
| Vermont | 19,248 | 279 | 200 |
| Virginia | 20,652 | 299 | 220 |
| Washington | 24,504 | 355 | 220 |
| West Virginia | 17,940 | 260 | 200 |
| Wisconsin | 23,148 | 336 | 220 |
| Wyoming | 22,404 | 325 | 220 |

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1/ U.S. Bureau of the Census, Public Employment in 1985 - Government Employment (Series GE85-No.1) at 8.

2/ The amount of the new Medicare tax is derived by multiplying the average employee's salary by 1.45%.

3/ Joint Committee on Taxation Staff, Data on Distribution by Income Class of Effects of H.R. 3838, Tax Reform Act of 1986 (JCX - 28-86) (October 1, 1986), Table 4.

### Statement In Opposition To
### Increase in Excise Taxes on Consumer Products
### Submitted on Behalf of Philip Morris Companies Inc.
By Hamish Maxwell
Chairman of the Board and Chief Executive Officer

I thank you for the opportunity to present this statement on behalf of Philip Morris Companies Inc., of which I am Chairman of the Board and Chief Executive Officer. We are opposed to an increase in selective excise taxes on consumer products in any form, whether the increase is accomplished through direct increases in the rates of such taxes, or through an indirect means such as an indexing mechanism.

Philip Morris Companies Inc. is among the world's largest manufacturers and marketers of tobacco, food and beer products. In addition to being the largest producer of cigarettes in the United States, with additional markets in more than 170 countries and territories, the Philip Morris family includes General Foods Corporation and the Miller Brewing Company. The 1986 operating revenues of Philip Morris were $25.4 billion. Philip Morris employs 73,000 people in the United States, including 20,000 related to tobacco and 11,000 to brewing.

Overall, beer and tobacco create economic and pleasurable benefits for 80 million beer drinkers and 60 million smokers. According to a study by Chase Econometrics,* the tobacco industry generated 710,000 jobs directly and another 1.6 million indirectly. It accounted for $31.5 billion of GNP in 1983 and for tax revenues of over $13 billion. The beer industry directly employs nearly 190,000 people and creates an even greater number of indirect jobs. These employment figures include a quarter of a million farm families who produce the 1.3 billion pounds of tobacco and the 7.6 billion pounds of barley, hops, corn and rice used in these industries each year.

Philip Morris was an early and vigorous supporter of the Administration's tax reform proposals, and we strongly supported Congressional enactment of the Tax Reform Act of 1986. The principles of that reform, as enunciated early in the legislative process by Secretary of the Treasury Baker, were to eliminate use of the tax system as a means "to favor one taxpayer over another, to favor one industry over another, to favor one form of consumption over another, or to favor one investment over another." In other words, the objectives were to eliminate preferred tax treatment of some taxpayers, to distribute the tax burden more equitably among all taxpayers and to make the tax system more neutral with regard to business investment decisions. These objectives were substantially accomplished in the Tax Reform Act of 1986, while benefiting American taxpayers through a reduction in tax rates.

Now, as one alternative to reducing the deficit, some have called for a massive increase in federal excise taxes on consumer products, and especially on beer and tobacco products, which are consumed by tens of millions of lower and middle-income individuals. This would amount to the largest excise tax increase in U.S. history. It would totally abrogate the benefits of tax reform for a substantial portion of the American people.

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*The Economic Impact of the Tobacco Industry on the United States Economy, Chase Econometrics, January 1986.

## I. CONGRESS SHOULD REJECT ANY FORM OF SELECTIVE EXCISE TAX INCREASE ON CONSUMER PRODUCTS

We believe Congress should reject any proposals that would raise selected federal excise taxes on consumer products. We believe that such tax increases, whether effected through direct or indirect means, should be rejected for the following reasons, which are explained more in detail below:

1. Excise tax increases are highly regressive, with increases in the excise tax on tobacco being the most regressive of all. Substantial excise tax increases would impact most heavily on large numbers of low and moderate income individuals who would be quick to notice the impact when they purchase tobacco, beer or gasoline.
2. The proposed excise tax increases would create economic distortions and run counter to the notions of fairness and economic neutrality reflected in the Tax Reform Act of 1986, adversely affecting decision-making by consumers in the marketplace. Low and moderate income Americans (in families with annual incomes of under $30,000) would find that these proposals would virtually wipe out the benefits of the income tax rate reductions which were promised to them by the President and Congress in enacting the Tax Reform Law.
3. Excise tax increases are inflationary.
4. Substantial increases in excise taxes would result in substantial economic injury to farmers, suppliers, distributors, and workers.
5. Beer and cigarettes are already heavily taxed, causing their consumers to bear more than their fair share of the costs of government.
6. Increased Federal excise taxes would impair a revenue source traditionally relied upon by State and local governments for a substantial part of their revenue.

### 1. Regressivity and Ability to Pay

Raising existing excise taxes on consumer products would hit hardest those individuals least able to pay.

This is because excise taxes on consumer products are not based on ability to pay. They require low- and middle-income consumers to use a larger fraction of their incomes to pay the taxes than citizens with higher incomes. That leaves smaller portions of their limited incomes available for spending on other goods and services. A study prepared by the Congressional Budget Office in January, 1987, for Senator George Mitchell found that the average increase in taxes as a percentage of income to be about twice as large for families with incomes between $10,000 and $20,000 as for families with incomes of $50,000 or more; and three times as large in the case of excise taxes on tobacco and beer. The study concluded:

> "An increase in the excise tax on tobacco would be the most regressive of all the taxes considered."

An analysis of excise tax and tariff proposals made by Senator Packwood in 1986, prepared by deSeve Economics** also concluded that excise tax increases would be borne disproportionately by low income taxpayers.

The rationalizations offered to suggest that excise taxes are not really as regressive as they appear are lacking in merit. Assistant Secretary Roger Mentz suggested in his

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**An Analysis of the Federal Excise Tax and Tariff Proposals in the Senate Finance Committee, deSeve Economics, April, 1986.

April 21, 1986 statement that excise taxes "appear to be more regressive than they would if lifetime consumption and income data were relied upon." Mr. Mentz's hypothesis suggests that since young families and retired people spend a higher proportion of their income than do middle-age families, over a lifetime everything works out even. Does anyone seriously believe that an elderly low-income person will not find increased excise taxes regressive because he had higher income before he retired? Does anyone seriously believe that young families will not find increased excise taxes regressive because they can look forward to the statistical probability of higher income levels at some future point in their lives? Although a novel approach for concluding that "lifetime" excise taxes are less regressive, one still must conclude that the impact of an excise tax increase is immediate and highly regressive.

Mr. Mentz further suggested that increases in selective taxes are not regressive because individuals who do not choose to consume the taxed goods do not have a tax burden. Neither Mr. Mentz nor the tax law should be defining for the American people the very questionable distinction between necessities and discretionary purchases. One of the underlying objectives of tax reform, as enunciated by Secretary of the Treasury Baker, was to eliminate use of the tax system as a means "to favor one form of consumption over another." Furthermore, the factor of choice does not alter in any way the basic fact that the increased tax will be very regressive to the low and moderate income people who in fact do consume the taxed articles.

Congress understandably decided in 1986 to reform our tax system to reduce the defacto regressivity of the income tax system, moving away from the same type of pernicious effects created by highly regressive excise taxes. Nothing has occurred in the few months since then to warrant a reversal of that decision.

## 2. The Proposals Reverse the Central Accomplishments of Tax Reform

The proposals to increase selective excise taxes on consumer products are also inconsistent with other primary objectives of last year's tax reform. The excise tax proposals would levy a huge increase on millions of individuals in lower economic brackets rather than distributing the tax burden more equitably among all. Instead of making the tax system more neutral with regard to business investment decisions, this new kind of "tax reform" would burden selected products and services, would not distribute the tax burden equitably, and would distort resource allocation.

Philip Morris is already among the highest effective rate income taxpayers in the corporate community, and we are dismayed to see a proposal for an increase in selective excise taxes when the increase is targeted primarily to three items -- tobacco, alcohol and fuels -- that are already among the most highly taxed items in America. From any reasonable perspective, the proposal would seriously undermine the goal of economic neutrality, which was a major objective of the Tax Reform Act of 1986.

When the Senate Finance Committee considered direct and indirect increases in excise taxes as part of tax reform last year, Assistant Treasury Secretary Mentz, in his statement before the Senate Finance Committee on April 21, 1986, indicated that key elements of tax reform were a maximum tax rate no higher than 35 percent and tax brackets that reduce taxes for middle-income Americans. More generally, the President explained tax reform to the American public on the basis that special tax breaks provided to some taxpayers require other taxpayers to pay more tax. Neither the President, nor Treasury, nor Congress suggested that income tax rates were too high because regressive excise taxes on consumer products were too low. On the contrary, original Treasury studies considered by the last Congress, rejected consumption taxes, like the excise taxes proposed here.

Furthermore, the excise tax increase proposals would effectively take away money that was promised taxpayers through a reduction in income taxes. This approach undercuts the substantial tax relief promised to millions of low and moderate income Americans in 1986.

The study prepared by the Congressional Budget Office in January 1987 for Senator George Mitchell shows that for families with annual incomes under $30,000, a $19 billion increase in existing excise taxes would eliminate the entire benefit of income tax reductions provided by the 1986 Tax Reform Act. The same study shows that such an increasewould cost the working poor more than double the savings they received under the 1986 Tax Reform Act.

As stated by Mr. Dennis Ross, Tax Legislative Counsel, on July 15, 1987, before this committee, "The administration believes that it is extremely important that we not undo any of the dramatic and important tax reforms that were accomplished last year."

Surely, taxpayers would regard it as an act of bad faith for Congress and the Administration to adopt a package of regressive excise tax increases which this year would take away what was given last year through tax reform.

3. Inflationary Effects on Consumers

Proposals to increase selective excise taxes on consumer products are bad economic policy, in part, because they would be inflationary, producing dramatic price increases in products on which the excise tax burden now falls so heavily. Virtually everyone, including the Treasury, believes that increased excise taxes would be passed on to consumers in the form of higher prices. Based upon the consequences of the major increase in excise taxes on cigarettes in 1983, all of the proposed increase in excise taxes on tobacco products would be passed on to consumers.

Over the first five years, the current proposal to double the tax on cigarettes would cause additional consumer expenditures of about $19 billion for cigarettes. Over the same period a current proposal to increase the tax on beer would cause additional consumer expenditures for beer of approximately $5.7 billion, equal to the entire revenue gain to the government. At retail, the initial impact of the proposal on the consumer would be a price increase of $1.60 per carton (16 cents per pack) of cigarettes and of $2.24 per case of beer. This inflationary impact would have an adverse impact on the economy as a whole and would ultimately worsen, not reduce, the deficit.

4. Injury To Farmers, Suppliers, Producers and Labor

Increases in selective excise taxes on consumer products are not only inflationary and thus damaging to consumers, but they also would severely and adversely impact producers, their labor force and shareholders, and farmers, suppliers and distributors. These increases also would have adverse impacts on the families and communities of all the workers and producers who supply not only the goods and services subject to these taxes, but also, on those untaxed goods and services that would be purchased in smaller quantities because of reductions in purchasing power brought on by the tax increases.

In the case of the tobacco tax, for example, figures derived from the Chase econometric model of the tobacco industry demonstrate that doubling the Federal excise tax would cause a loss of 28,500 American jobs, a decrease of about $110 million in sales, and 37.5 million fewer pounds of tobacco purchased. We believe these estimates are on target, since the 8-cent increase in 1983 (which doubled the federal cigarette excise tax) reduced GNP by $800 million and has caused, to date, at least a $2.5 billion loss of retail sales and lost job opportunities for 14,600 workers in tobacco manufacturing and distributing. The 1983 increase in cigarette excise taxes also resulted in annual lost sales of 29.6 million pounds of tobacco, and undoubtedly exacerbated the tobacco surplus problem, which is currently at a level of 1-1/4 billion pounds of tobacco.

Another doubling of the cigarette excise tax would cause substantial and irreparable harm to American tobacco farmers, their families, and their communities. These communities, concentrated in the Southeastern tobacco growing states, bear the brunt of the economic costs of increased excise taxes. In effect, an excise tax increase would force some of our least affluent states to subsidize the rest of the country.

5. The selected products already are heavily taxed

While the consumer price index increased about 322% from 1951 through 1986, the combined Federal, state and local cigarette tax collection increased over 602% throughout the same period. It is manifestly unfair for a substantial, disproportionate tax burden to be placed on a narrowly targeted segment of the American public to pay for deficit reductions designed to benefit the country as a whole. This is true whether the targeted segments turn out to be the farmers, suppliers, the labor force and owners of the selected producer, or the consumers of its product.

6. Federal excise tax increases would impair a revenue source used by state governments

Raising existing Federal excise taxes would impair a revenue source traditionally relied on by state and local governments for a substantial part of their revenues. Federal, state and local excise tax collections on cigarettes currently amount to $9.17 billion annually. In addition to the 16-cent-per-pack Federal excise tax, the average combined state and local tax is over 21 cents, so combined taxes average over 37 cents per pack.

The National Governors' Association has already published a position paper critical of proposals to raise Federal excise taxes. The National Conference of State Legislatures forecasts a $257.3 million loss to the states in fiscal 1988 and nearly $1.3 billion loss over five years if higher federal excise taxes on cigarettes are enacted.

7. Additional Points

User Fee

In a June, 1987 report, Office of Management and Budget Director James Miller suggested several inappropriate criteria as excuses for selectively raising excise taxes.

In particular, he asserted that it is appropriate to increase the rate of excise tax as an "abuser fee" to pay for social costs associated with the use of that product.

Although he indicated that tobacco products and alcoholic beverages fall in this category, producing what he called "negative externalities", he provided no usable criteria for measurement of the cost to society for these or any other products. He implied that only a few products and activities fall in this category.

We contest the notion that beer and tobacco create any scientifically measurable social costs. They do create enormous economic and pleasurable benefits for 80 million beer drinkers and 60 million smokers. According to a January, 1986 study by Chase Econometrics***, in 1983 the tobacco industry

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***A Quantitative Analysis of the Packwood Tax Reform Proposal, Chase Econometrics, April 10, 1986.

generated 710,000 jobs directly and another 1.6 million indirectly. It accounted for $31.5 billion of GNP in 1983 and tax revenues in excess of $13 billion. The beer industry directly employs nearly 190,000 people and creates an even greater number of indirect jobs.

Moreover, there are few, if any, products and activities for which one cannot assert social costs. This type of so-called test does not advance true tax reform. One of the purposes of tax reform was to eliminate the subjective evaluations of different industries. Such evaluations have encumbered the tax code with numerous exceptions, to the detriment of free economic decision making.

From a broader perspective, the viewpoints expressed by Mr. Miller are totally inconsistent with the position expressed many times by President Reagan that consumer choices should be determined by the market place and not by the government.

### Prior Legislative History

In 1965 Congress wisely recognized the undesirability of imposing selective excise taxes on consumer products as a fair way of raising revenue. In the Finance Committee Report accompanying the 1965 legislation which repealed a panoply of selective excise taxes burdening consumer products, the Committee condemned their use as a "source of undesirable discrimination." The Committee determined that "these selective excise taxes tend to reduce sales and therefore reduce incomes and jobs in the industries which produce the taxed goods. In these ways selective excise taxation results in arbitrary and undesirable distortions in the allocation of resources and in this manner interferes with the free play of competitive markets." The Committee further concluded that excise taxes "are regressive in their impact, absorbing a larger share of the income of low-income persons than of those with higher incomes."

The Committee's unequivocal and accurate criticisms of selective excise taxes are as appropriate today as they were in 1965. Unlike some of the targeted products, the deficiencies of selective excise taxes on consumer products do not improve with age.

## II. SPECIAL PROBLEMS WITH PROPOSALS FOR INDEXING SELECTIVE EXCISE TAXES

One technique proposed as a means of raising excise taxes is particularly questionable. Indexing federal excise taxes on tobacco, alcohol and fuels, in addition to creating many technical problems in application, would heighten all the previously described negative consequences to consumers and producers. Indexing federal excise tax rates on alcohol, tobacco products and fuels in fact is simply a means to increase excise taxes on selected consumer products. Accordingly, the proposal suffers from all of the infirmities previously described in this statement, and for that reason alone should be rejected by this committee. Moreover, tying the rate of tax on these selected items to future consumer price increases would heighten the adverse features inherent in selective excise taxes on consumer products. The price adjustment feature would tend to make the regressive and economically distortive aspects of the tax permanent, rather than soften with time. If tax revenues are to be increased to reduce the deficit, the burden of the additional taxes should be as widely distributed as possible. The proposal calls upon the producers and consumers of the taxed products to bear a hugely disproportionate share of the increased tax burden.

It has been suggested that indexing the excise tax rates on these products is consistent with the concept of indexing income tax rate brackets and depreciation rates. However, this correlation does not exist.

The effect of indexing income tax rate brackets and depreciation is to prevent automatic increases in federal revenues (and consequent increases in government spending) with each round of inflation. The effect of the proposal to index excise taxes is to ensure automatic increases in federal revenues (and consequent increases in government spending) with each round of inflation.

One of the principal arguments for income tax rate bracket indexing is that the government should not benefit from increased revenues caused by inflation that the government has, at least in part, created. Bracket indexing addresses another concern that automatic increases in federal revenue create automatic increases in government spending. Thus, indexing federal excise taxes to price increases would be the opposite of indexing income rate brackets and depreciation. In fact, the reasons advanced in support of indexing income rate brackets and depreciation constitute strong grounds for not indexing excise tax rates.

It would also be unfair to index the rate of the manufacturing excise tax on tobacco products and alcoholic beverages to consumer price levels of such products, since a substantial portion of the consumer prices of such products is attributable to the Federal excise tax and various state taxes. When non-retail taxes are increased, Congress imposes "floor stocks taxes" on goods taxed at the old rate which have not yet been sold at retail. The purpose is to prevent tax avoidance and unfair competition by wholesalers and retailers who might stock up on the product before the effective date of the tax increase. With indexation, if this type of tax avoidance is to be prevented, a floor stocks tax will have to be imposed frequently, each time the tax is increased. Since floor stocks taxes involve wholesalers and retailers (not the smaller groups of manufacturers and importers), they are difficult to administer. Thus, indexing will result in either the imposition of a procedurally troublesome floor stocks tax or an opportunity for avoidance and unfair competition each time the rate is changed.

Most important, the indexing proposal would remove from Congress its legislative prerogative to review all appropriate factors before increasing tax rates. Automatic tax increases are a poor substitute for Congressional determinations.

## III. SUMMARY

We at Philip Morris Companies understand what increasing selective excise taxes imposed on certain consumer products can mean. Our company is among the world's largest manufacturers and marketers of tobacco, beer, and food products. In addition to being the largest producer of cigarettes in the United States with additional markets in more than 170 countries and territories, Philip Morris includes General Foods Corporation and the Miller Brewing Company. 1986 operating revenues were $25.4 billion.

Overall, beer and tobacco create benefits for 80 million beer drinkers and 60 million smokers. The tobacco industry accounted for $31.5 billion of GNP in 1983 and tax revenues in excess of $13 billion. The tobacco industry generates 710,000 jobs directly and another 1.6 million indirectly. The beer industry directly employs nearly 190,000 people and creates an even greater number of indirect jobs. These employment figures include a quarter of a million farm families who produce the 1.3 billion pounds of tobacco and the 7.6 billion pounds of barley, hops, corn and rice used in these industries each year.

Like other major worldwide suppliers of consumer products, we at Philip Morris Companies have in the past paid, and are presently paying, substantial sums in Federal, state, local and foreign taxes. We are proud of the contributions we have made through our tax payments to the fiscal integrity of governments, and through our business activities generally to a strong economy. We were early and vigorous supporters of tax reform proposals designed to yield a fair, broad-based, and revenue effective tax system. We remain committed to such principles. We hope that last year's successes toward achieving such a system will not be quickly put aside this year or at any other time in the quest for needed tax revenues.

The tens of millions of voters who would have to pay for deficit reduction through substantial increases in excise taxes on products they consume can be expected to notice the size of excise tax increases such as those some have proposed. The number of individuals paying these increased prices would be very large, including 80 million consumers of beer and 60 million consumers of tobacco products. And the working poor will be aware that the promise of tax reform has been taken away from them.

For the reasons stated above, we urge the Committee to formulate deficit reduction proposals in accordance with principles designed for economic neutrality and growth. We urge the Committee to reject any proposals to increase existing excise taxes on consumer products, regardless of whether the increase would be accomplished directly through specific increases or indexing or indirectly by other means.

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# TESTIMONY OF THE
# PUBLIC SECURITIES ASSOCIATION
# SUBMITTED TO THE
# COMMITTEE ON FINANCE
# U.S. SENATE

JULY 1987

The Public Securities Association ("PSA") welcomes the opportunity to comment on the revenue options before the Committee on Finance. PSA is an international trade association which represents approximately 300 banks, dealers and brokers that underwrite, trade and distribute U.S. government and federal agency securities and state and local government ("municipal") securities, and mortgage-backed securities. We appreciate the significance of the issues before the Committee and welcome the opportunity to submit this written testimony.

## A Securities Transfer Excise Tax

A number of revenue options before the Committee involve excise taxes, of which one, a Securities Transfer Excise Tax ("STET") could have particular impact on the public securities markets. Characteristic of excise taxes as a class, a STET would tend to distort economic activity, biasing investor preference away from securities subject to the tax and in favor of other securities, whether domestic or foreign. The nature of the distorting bias within the capital markets would depend, of course, on how broadly the STET would be structured. If it were very broadly cast, at the margin it would distort decisions between investment and consumption, favoring the latter.

An additional distorting feature of a STET would be its discouragement of otherwise economic securities transactions, leading to lower market trading volume. For example, a Congressional Research Service study concluded that a transfer tax applied only to stocks would cause stock trading volume to decline by 12.7% relative to its level in the absence of the tax.[1] Reduced trading volume would also be expected in fixed income securities (e.g., government securities and municipal bonds) with greater impact the higher the current turn-over in secondary trading.

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[1] Donald W. Kiefer, "A Stock Transfer Tax: Preliminary Economic Analysis," Congressional Research Service Report No. 87-2785, March 31, 1987. The reduction in trading volume also calls into question revenue estimates based on historical volume levels.

Lower trading volume results in reduced liquidity in the affected securities. Less liquid assets are less desirable to investors, resulting in lower securities prices, everything else being equal.

Moreover, as a STET would decrease the after-tax yield to holders of securities, prices would have to fall to reach a competitive equilibrium vis-a-vis yields of alternative available investments. The loss in price of outstanding securities made subject to a STET would accrue to the current holders of those securities, constituting a tax on their capital (as opposed to their income).

In considering the incidence of a STET, it should be noted that, while the lowest income households would be spared from the direct impact of such a tax, its impact would be felt broadly across the remainder of the population. In addition to the millions of individual investors in stocks and bonds, concentrated in higher income households, many of the low to moderate-income individuals, including retired persons, indirectly hold a large amount of securities through pension and retirement funds, including public employee pension funds. All these funds would decline in value as a result of imposing a STET to the extent securities in the applicable portfolios were subject to the tax.

PSA is particularly concerned about the possible application of a STET to public securities. If a STET were applied to new issues or secondary transactions in municipal and/or U.S. government securities, it would ultimately be a tax on governments. Similarly, applied to mortgage-backed securities--whether pass-through or government-guaranteed mortgages underlying collateralized mortgage obligations--the STET would be a tax on housing.

Prices will adjust in the public securities markets to account for a tax. Consider a STET applied on new bond issues. Since the tax decreases the after-tax yield of a new issue to the investor, investors would require a higher interest rate and pay a lower price for the new bonds in order to maintain their current yields. Lower prices for public securities would increase the cost of borrowing to governments, since more debt must be incurred to raise a given amount of revenue and repayment will be at a higher interest rate. In this way, the STET, if applied to public securities, becomes a tax on governments, or on housing, in the case of mortgage-backed debt.

With the imposition of any excise tax, part of the burden is borne by the seller (borrower), and part by the buyer (investor). In the case of a STET, investors suffer somewhat lower after-tax yields, and issuers suffer lower prices (higher coupon rates). The relative distribution of the burden between investors and issuers depends upon the flexibility of the players. Whoever can leave the market more readily in favor of substitutes will bear less of the tax burden. In the case of public securities, investors in public securities have many more alternative opportunities to invest their funds than governments have to raise funds.[2]

But regardless of the exact distribution of burden between investor and issuers, governments would bear some of the tax burden under any version of a STET that is imposed on their securities. Bond prices would be forced down to maintain competitive after-tax yields, and the costs of borrowing would rise.

A STET would become a tax on governments even if applied only to secondary transactions of public securities. As noted above, a STET would reduce trading volume and lower securities prices below their present levels. These effects would make new issues of public securities less attractive because they would be less liquid and because investors would face a lower resale price for the securities should they not hold them to maturity. Hence, even if the STET were not applied directly to new issues, investors would still pay less for them, and prices of new public securities would fall. Again, the cost of borrowing to governments would rise.

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[2] In essence, governments, which lack the option to issue equity, must enter the bond market to raise revenue. Investors, on the other hand, can invest a variety of debt and equity instruments, futures, options, money market funds, certificates of deposit, and passbook accounts and real estate, as well as art and precious metals. Investors can also invest their funds overseas. It is true that a broad application of a STET would tend to diminish the attractiveness of these alternatives, but, many of the above alternatives would clearly be out of the reach of any STET. Under most conceivable versions of the STET, governments would have fewer alternatives than investors, and hence would be forced to bear the primary burden of the tax.

## Tax-Exempt Financing

The effects on tax-exempt financing of the 1986 Tax Reform Act were extensive and substantial. Provisions such as arbitrage rebate, tighter restrictions on "private activities" bonds, cost of issuance limitations, information reporting requirements and minimum tax have required the public finance sector (issuers, underwriters and investors) to adjust its mode of operation significantly. The effects on the sector are in part reflected in statistics on market volume, which is expected to be substantially lower than in the last three years.

The complexity and breadth of the '86 Act with respect to tax-exempt financing is only beginning to be fully understood and appreciated. Clearly, the public finance sector is still reacting and adjusting to Tax Reform. Further, some provisions of Tax Reform will come into effect for the first time in 1988, including another reduction in the state-wide per capita volume caps for most "private activity" bonds from $250 to $150.

Given the extent of the provisions in the '86 Act in this area, PSA appreciates the sensitivity shown in the options pamphlet. Not only would it be difficult to raise any additional revenue from further restricting tax-exempt financing, but any further amendments, however limited, would only add to the uncertainty in an already confused market.

With respect to these issues in the options book, PSA would like to comment specifically on the proposal concerning the alternative minimum tax, which would expand the list of preference items to include tax-exempt interest from "additional bonds." PSA strongly opposes this option for three reasons.

First, inclusion of the interest on public purpose bonds, including general obligation bonds and other bonds issued to finance basic governmental facilities, among the preference items seems to contradict some of the basic tenets of the '86 Act. The proposal would levy direct taxation on the interest on state and local government bonds used to finance what Congress has deemed to be the most essential of government services.

Second, extending the minimum tax to outstanding general obligation and private activity bonds would cause an immediate drop in the market value of such bonds (held by a wide range of individuals).

Finally, extending the alternative minimum tax to "additional bonds" is inefficient. It is unlikely that any significant revenue would be raised. Bonds that are subjected to the minimum tax have higher yields than other tax-exempt bonds, ranging from 25 to 40 basis points (0.25-0.4%). Since only a portion of all taxpayers are subject to the minimum tax, the bulk of taxpayers investing in "minimum tax bonds" receive the higher yields tax free, a windfall that only raises the costs of projects financed by these bonds. Expansion of the minimum tax would merely raise yields on additional bonds and interest rates to issuers, without a corresponding increase in revenue to the Treasury.

## Revenue Options

PSA realizes that the Committee must develop a package to raise substantial revenue in order to meet deficit targets. We support this effort, and suggest that actions taken to raise revenue should be consistent with certain guidelines.

In particular, PSA urges the Committee to provide for additional revenue without increasing the cost of borrowing to government--federal, state and local. Increased governmental borrowing costs would only exacerbate the existing strains on government finances. Moreover, if governments are deterred from delivering essential, legitimate public services because of the high cost of financing them, the nation risks further erosion of its infrastructure. Over the longer run, this erosion would lead to greater public financial responsibilities in order to tend to the neglect.

PSA is sympathetic with those who argue that this is too soon to tinker further with the basic tenets of the 1986 Tax Reform. The 1986 legislation made sweeping changes, many of which are still not

**well-understood. Revisions at this time to the important provisions of the 1986 Act would only confuse matters.**

**Finally, the Committee should develop a revenue package that will not unnecessarily distort economic decision-making. The '86 Act sought to neutralize the effects of the tax code on everyday economic choices; the '87 Reconciliation Act should not, in our view, add new distortions.**

**To summarize, the new revenue package should maintain the principle of economic decision-making, should hold constant the basic provisions of the 1986 Tax Reform Act, and should avoid increasing the cost of borrowing to governments.**

**Thank you for this opportunity to comment on the revenue options before the Committee.**

# TESTIMONY OF
# JOHN C. BUTLER, III
# PRINCIPAL
# PUTNAM, HAYES & BARTLETT, INC.

## COST OF A NATIONAL VACCINE COMPENSATION PROGRAM

I am John C. Butler, III and I am a Principal of Putnam, Hayes & Bartlett, Inc. (PHB). PHB is an economic and management consulting firm specializing in analysis of economic issues concerning the environment, energy, product liability, antitrust, and international trade, among other issues. My professional experience has centered on public policy analysis of environmental and product liability issues. Prior to joining PHB, I was employed by the World Health Organization, the United Nations Environment Programme, and the Environmental Protection Agency. Since 1984, I have been engaged by the American Academy of Pediatrics (AAP) to estimate the cost of vaccine compensation legislation. In preparing my testimony, I have sought the expert advice of members of the Academy, including Dr. John Freeman, Professor of Neurology and Pediatrics at Johns Hopkins University, and other experts. Today, I will summarize my analysis of the likely cost of a vaccine compensation program and estimate a vaccine surcharge to create a self-financing program. I will also compare the cost estimate prepared by the Congressional Budget Office (CBO) with my cost estimate.

## CONCLUSIONS

As the Committee examines PL 99-660, I suggest it consider several changes that could increase the attractiveness of the Vaccine Compensation Program to claimants and, at the same time, reduce the cost and financial risk of the Program. (The recommended changes appear to be acceptable to all interested parties.) Specifically:

- Lump sum payments should be substituted for the current pay-as-you-go approach. This change would reduce the financial risk to the Compensation Program in later years.
- Limit compensation awards only to those suffering long-term injury or death rather than compensating those with less severe injuries. This change cuts annual program costs by a factor of three.
- Delay compensation payments until one year after a tax on vaccines is imposed. This change would avoid the need to borrow Program startup costs.

I would also suggest the Committee consider reducing the limit on past claims from 3,500 to about 2,000. This would contribute to financial stability and predictability of Program costs.

With these changes to PL 99-660, the likely costs of the Program are given in Exhibit 1 (see page 6). Program costs would be minimal in the first year, peak in the second year at $118 million, and in the third year at $90 million. Costs in the fourth year would drop to $36 million. Costs in later years are expected to increase with inflation.

Cost estimates prepared by the CBO are more than three times higher than these estimates. The principal reason for this difference is that CBO assumes an incidence rate of serious adverse reactions more than three times the rate assumed by Academy experts and used in preparing my cost estimates. The CBO ignores the findings of recent CDC surveillance studies on the rate of adverse vaccine-related reactions. CBO based its incidence estimate on a 1980 OTA study, which the OTA says produces incidence estimates consistent with those used in this testimony, and not those used by CBO (see page 8).

I understand that the portion of Program costs attributable to past injuries may be covered by a general revenue appropriation. Hence, the vaccine surcharge would cover the cost of future injuries. Finally, due to the uncertainties in estimating Program costs, I believe it is prudent to add 25 percent to the cost estimates I have developed to ensure financial stability of the Program. Following the above suggestions, I recommend the Committee adopt the following per dose surcharges to fund the Compensation Program: DPT, $2.23; DT, $.03; MMR, $2.17; Polio, $.14. These surcharges would add 25 percent and 12 percent to the private sector cost of the DPT and MMR vaccines, respectively. The surcharge and percentage cost increase would be much less for the other vaccines. Since the recommended surcharges include a 25 percent cushion above expected costs, the Compensation Program should be solvent under a wide range of conditions.

## INTRODUCTION

In 1986, approximately 46 million vaccines were administered to children to immunize them against such diseases as tetanus, diphtheria, pertussis, polio, measles, mumps, rubella, and others under mandatory vaccination programs. These immunization programs save many children from disability and death, as well as protect society in general from disease epidemics. However, each year a small number of children have severe reactions to vaccines that result in permanent disability and, in some cases, even death. It is unfair to expect parents with children suffering severe vaccine-related injuries to shoulder the burden of medical, rehabilitative, and other related expenses, since society is the beneficiary of compulsory immunization laws. Therefore, it is only fair for society to provide prompt compensation for those few injured in the process.

Legislation signed by the President last year (referred to as PL 99-660) established a program to compensate victims of adverse reactions following immunization. This program will not take effect until Congress passes legislation to fund the National Vaccine Compensation Program. I use the legislative framework described in PL 99-660 as a basis for forecasting the cost of the program. However, my cost analysis differs from PL 99-660 in several important ways. First, the statute assumes claimants would be paid expenses as incurred on an annual basis. In my analysis, it is assumed claimants would receive a lump sum award which would equal the net present value (NPV) of expected future expenses, including lost earnings. The National Vaccine Compensation Program could use the lump sum award to purchase from private insurers an annuity which would provide the claimant with guaranteed payments over his or her lifetime.

Second, PL 99-660 would provide compensation not only for those suffering long-term injury or death but for adverse reactions of short duration. I have shown in previous testimony that providing compensation for these short-term and less severe reactions could treble annual program costs.* Various proposals which appear to be acceptable to interested parties would allow PL 99-660 to compensate only those suffering injuries lasting more than six months in duration. My cost estimates assume this type of change to the statute would be enacted. Finally, I assume that compensation payments to families would not begin until one year after a tax on vaccines was imposed. This delay ensures that the Compensation Program would not need to borrow startup funds.

## SUMMARY OF FINDINGS

To estimate the likely cost of the program, the Committee needs to determine:

- The number of cases of each type of illness category that would receive compensation.
- The compensation cost per case for each type of illness category.
- The number of past cases and the compensation these cases would receive.

Once the cost of the Compensation Program is known, then the Committee can determine an appropriate vaccine tax rate to pay for the Program.

### Number of Claims Expected

The Vaccine Injury Table in PL 99-660 determines the type of presumptively compensable injuries. According to the latest data and information available from the Centers for Disease Control (CDC), Department of Health and Human Services, and in consultation with the AAP, I assume the following annual incidence of adverse reactions following immunization:

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* See testimony of John C. Butler, III on Cost of A National Vaccine Compensation Program, before Subcommittee on Select Revenue Measures, House Ways & Means Committee, March 4, 1987.

| | Annual Incidence* |
|---|---|
| Deaths | 11 |
| Chronic cases with long-term injury | 62 |

In addition, I assume that 1,032 past cases, which is approximately equal to one-half of the long-term injuries or deaths expected to be associated with vaccines during the last 24 years, would receive compensation for future medical expenses and rehabilitation costs as described in the statute.

Cost Per Case

The lump sum costs per case, including the cost of reasonable attorney fees and program administrative costs for new cases, are as follows:

| | Present Value Cost** |
|---|---|
| Death | $280,000 |
| Chronic cases | $450,000 |

In cases involving death of an infant, the cost includes a $250,000 payment to the family plus attorney fees and administrative costs. For chronic cases, lost earnings account for 42 percent of case costs, medical and rehabilitation costs (less payments received from insurance companies) account for 25 percent, pain and suffering accounts for 22 percent, and legal and administrative costs for 11 percent. Cases incurred prior to enactment receive compensation for medical expenses and rehabilitation costs incurred after enactment. The cost per case depends on the claimant's age.

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* Incidence estimates are based on consultations with AAP experts and on a letter to Mr. Doug Campbell from James D. Mason, Assistant Surgeon General and Director of Centers for Disease Control, October 24, 1986.

** See March 4 testimony of John C. Butler, III for a description of cost assumptions and approach used in developing projections.

## Compensation Program Cost Projections

Given the above estimates on the number of cases, the average cost per case, and the assumptions on changes to PL 99-660 (namely, the use of lump sum awards, compensation awards only for those suffering long-term injury or death, and the staggering of compensation payments and tax receipts), the likely cost of a compensation program is shown in Exhibit 1. First year costs are minimal because compensation payments are delayed until the second year. High second and third year costs result from payment of past claims in those years, and payment of both first year and second year new cases in the second year. Costs in later years cover vaccine injuries or deaths that occur in those years.

The estimates shown in Exhibit 1 are based on the latest information on cost of treatment and rehabilitative care, and on the advice of expert pediatricians on the likely number of compensable adverse reactions following immunization. However, cost estimates are imprecise because of limitations in estimating incidence, uncertainties in the size of pain and suffering awards, the number of past claims, and so forth. Therefore, given these limitations, I believe it would be prudent to increase these estimates by 25 percent.

## Comparison With CBO Cost Estimates

The Congressional Budget Office has recently prepared several alternative estimates of the National Vaccine Compensation Program established by PL 99-660.* The alternative CBO estimates are composed by varying the assumed lifetime of injured claimants and the discount rate used to value future payments. While the CBO estimates do not account for the proposed changes to PL 99-660 as suggested above, they can most readily be compared to a cost estimate included in my March 4, 1987 testimony. Exhibit 2 compares the CBO's estimate used by the staff of the Joint Tax Committee to calculate vaccine surcharges with my earlier cost estimate. This Exhibit shows the CBO estimate to be more than three times higher than my estimate. The principal reason for this result is that the CBO incidence estimates -- and, therefore, claim rate -- are more than three times higher than the incidence estimates I used. Exhibit 2 also shows that if the CBO incidence figures were replaced with the incidence figures I used, then the cost forecasts are in substantial agreement.

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* See June 8, 1987 memorandum to the Joint Tax Committee on "Net Present Value Estimates and Annual Cost Estimates for the National Vaccine Injury Compensation Trust Fund."

## EXHIBIT 1

## ANNUAL VACCINE COMPENSATION PROGRAM COST

($ Millions)

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|
| Past Claims | - | 53 | 55 | - | - |
| New Claims | - | 64 | 34 | 35 | 37 |
| Administrative Costs | 2 | 1 | 1 | 1 | 1 |
| TOTAL | 2 | 118 | 90 | 36 | 38 |

EXHIBIT 2

COMPARISON OF CBO AND PHB COST PROJECTIONS

ANNUAL PROGRAM COSTS
($ Millions)

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|
| Butler Core Case Estimate (March 4, 1987 Testimony) | 125 | 36 | 37 | 39 | 41 |
| CBO Estimate (65 year life expectancy, 2 percent discount rate) | 441 | 133 | 139 | 145 | 154 |
| CBO Estimate with Butler (CDC) Incidence Figures | 145 | 40 | 42 | 44 | 46 |

One might ask: How could the incidence estimates be so different? As mentioned earlier, estimating the number of serious adverse reactions cannot be accomplished with certainty. There are conflicting incidence estimates of various reactions, and no one really understands why these adverse reactions occur. The CBO assumed 226 serious adverse reactions would occur annually; I assume 73. The CBO incidence figures were derived from a 1980 study prepared by the Office of Technology Assessment (OTA).* In that study, the authors claim that the incidence figures were only "reasonable ballpark estimates." Furthermore, the authors state: "We suspect that this estimate is likely to be in error on the high rather than on the low side." (It should be noted that the American Academy of Pediatrics used these incidence data until better data became available.) The incidence estimates I used were based on the advice of Academy experts and a review of two recent CDC surveillance studies published subsequent to the OTA report. The surveillance studies reviewed the results of CDC's monitoring system, which gathers information on the number of vaccine-related injuries. Based on an analysis of these data and other information, the Academy believes that as many as 75 vaccine-related injuries could occur per year.** This figure is about one-third the incidence rate assumed in CBO's current cost estimate.

In a recent communication to Congressman Waxman, the OTA has reviewed various estimates of the number of serious reactions associated with childhood vaccines.*** The OTA concluded that "a reasonable estimate derived from these analyses is that between 60 to 80 long-term disabilities and deaths occur annually, with deaths accounting for about 10 percent of the cases." The OTA indicates that its estimate of 60 to 80 serious reactions is "generally compatible" with the estimates I have used in this testimony. The OTA also says that "a federal compensation program can be expected to stimulate reporting of additional, unreported injuries, as well as injuries that may not be associated with vaccination, which could be a significant number." While the statute's limitations requiring compensable events to occur within three days of vaccination provides safeguards on the number of cases, I believe it would be prudent to increase the cost projections by 25 percent to account for a possible increase in the number of cases reported.

In sum, the CBO cost projections are more than three times higher than my forecasts. The principal reason for this result is that CBO incidence assumptions are three times higher. CBO bases its incidence assumptions on a 1980 OTA report, which the OTA says produces estimates of long-term disabilities and deaths that are consistent with the estimates I used, not those estimates used by CBO. Since I suggested that PL 99-660 be amended to clarify that only long-term injuries plus deaths should receive compensation, I believe the appropriate cost estimates are those I present in this testimony. Finally, I would increase by 25 percent the cost estimates given in Exhibit 1 to account for possible underreporting of injuries.

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* Compensation For Vaccine-Related Injuries: A Technical Memorandum, Office of Technology Assessment, November 1980.

** See letter to Rudolph G. Penner, Director, CBO, from Dr. Martin H. Smith, President, American Academy of Pediatrics.

*** See letter to the Honorable Henry Waxman from John Gibbons, Director, Office of Technology Assessment, July 14, 1987.

## Vaccine Surcharge

The Vaccine Compensation Program may be financed by a surcharge levied on all vaccine manufacturers. This vaccine surcharge would be added to the cost of each vaccine in proportion to the number of adverse events associated with that vaccine. For example, 76 percent of all serious vaccine injuries are believed to be caused by vaccines containing the pertussis antigen. Hence, the surcharge on vaccines containing the pertussis antigen would account for 76 percent of revenues.

The procedure for determining the per dose surcharge is as follows:

- Allocate program costs to each vaccine type in proportion to the number of adverse events caused by that vaccine.
- Divide the allocated program costs by the expected number of doses distributed.
- Follow the Joint Tax Committee's convention for ensuring excise taxes are tax revenue neutral and increase the surcharge computed in step 2 by one-third.

Finally, in determining the vaccine surcharge I consider two scenarios. First, I assume that the surcharge would cover all expenses for past and future claims. Second, I assume a general revenue appropriation would cover compensation for past claims and the surcharge would cover all other program costs. Exhibit 3 lists the vaccine surcharges necessary to cover the cost of all expected past and future claims. The surcharges are constant at a high level for the first three years because of the need to pay past claims. The surcharges decrease in the fourth year and in later years because only new claims would be paid in those years.

Exhibit 4 lists the vaccine surcharges needed to cover the remaining program costs when past claims are paid by general revenues. In this case, a levelized surcharge for the first five years was developed. Finally, to account for possible underreporting of adverse reactions, I believe it would be prudent to increase the surcharge by 25 percent to ensure the solvency of the program. These surcharges are also listed in Exhibit 4.

## EXHIBIT 3

## VACCINE SURCHARGE TO COVER TOTAL PROGRAM COST
($ Per Dose)

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|
| DPT | $3.52 | $3.52 | $3.52 | $1.85 | $1.95 |
| DT | .04 | .04 | .04 | .03 | .03 |
| MMR | 3.43 | 3.43 | 3.43 | 1.81 | 1.89 |
| POLIO | .23 | .23 | .23 | .12 | .13 |

The surcharge variation by vaccine is based on the relative incidence of adverse reactions as described in HR-5546.

Note: Subsequent years' surcharges would increase with inflation.

## EXHIBIT 4

## VACCINE SURCHARGES TO COVER COST OF FUTURE CLAIMS*
($ Per Dose)

| | Levelized Surcharge Years 1-5 | 25% Buffer Surcharge Years 1-5 |
|---|---|---|
| DPT | $1.79 | $2.23 |
| DT | .02 | .03 |
| MMR | 1.73 | 2.17 |
| POLIO | .12 | .15 |

The surcharge variation by vaccine is based on the relative incidence of adverse reactions as described in HR-5546.

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* Past claims are assumed to be paid by a general revenue appropriation. Hence, the surcharges only need to cover the program costs of future claims.

At this level, the $2.23 surcharge on DPT vaccines and the $2.17 surcharge on MMR vaccines would increase the private sector costs of these vaccines by 25 percent and 12 percent, respectively.

One key objective of the program is to ensure that it is self-financing, that is, the program would remain solvent under a wide range of conditions. Exhibit 5 shows the Vaccine Compensation Program revenues, costs, and cash balances assuming that 25 percent more claimants than expected receive compensation.* As the Exhibit shows, even if 25 percent more claims are paid than expected, a positive cash balance in the fifth year of about $1 million would result. If the number of claims paid were equal to the CDC incidence assumptions (i.e., the expected number of claims), then the cash balance would be given by the curve labeled Expected Cash Balance. The size of the expected cash balance is the safety margin on the solvency of the Program. As the Exhibit indicates, the Vaccine Compensation Program with the suggested vaccine surcharges could remain solvent under a wide range of conditions.

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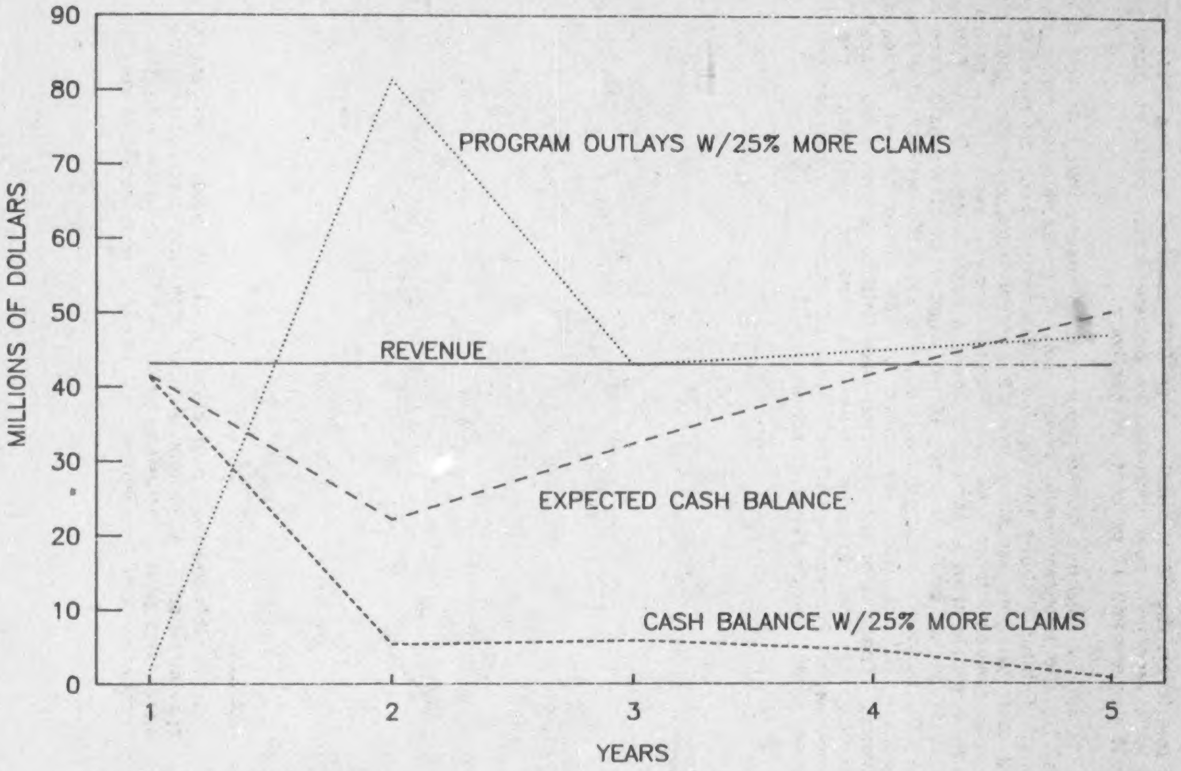
* This Exhibit assumes past claims would be paid by a general revenue appropriation. A similar exhibit including past claims (not shown) shows the same conclusions, that is, the Program with the suggested surcharges could remain solvent under a wide range of conditions.

Exhibit 5

## VACCINE PROGRAM REVENUES AND COSTS



SOURCE: Putnam, Hayes & Bartlett, Inc., July 1987.

# STATEMENT OF

# WILLIAM R. HOWELL

# ON BEHALF OF

# THE RETAIL TAX COMMITTEE OF COMMON INTEREST

# SUBMITTED TO

# THE COMMITTEE ON FINANCE

# UNITED STATES SENATE

"Revenue Increase Options"

August 12, 1987

* * * * * * *

## Introduction

I am William R. Howell, Chairman of the Board and Chief Executive Officer of the J. C. Penney Company, Inc. I am presenting this statement on behalf of the ten general merchandise retailing companies and two major retail trade associations which are members of the Retail Tax Committee of Common Interest, who have worked cooperatively on federal tax policy issues for approximately ten years. A list of our members is attached.

This statement is presented to the Committee to urge that your consideration of potential tax increases needed to meet the FY 1988 budget reconciliation requirements exclude those options which would undermine the significant contribution that the Tax Reform Act of 1986 (the 1986 Act) made toward a more efficient and equitable federal income tax system. Specifically, we urge that the individual and corporate income tax rate reductions be allowed to go into effect as enacted without delay or revisions. Our support for full implementation of these rate reductions includes opposition to a surtax or any other proposal which would increase tax rates in less visible ways. Increasing tax rates would not only break an explicit understanding between the Congress and taxpayers, it would also provide a powerful argument for those who would seek to reinstate special provisions which were repealed or limited in conjunction with rate reductions last year.

We also urge that other options, including limitations on the deductibility of advertising costs, increases in the tax costs of maintaining pension plans and providing certain other benefits to employees, imposition of certain new excise taxes, restrictions on or repeal of the LIFO method of accounting for inventories, and increases in FUTA taxes, each of which would adversely impact our already high tax burdens, be set aside. Finally, we recommend that major new tax systems not be considered in the context of FY 1988 reconciliation legislation.

These comments are limited to those options discussed in the revenue options pamphlet, issued by the staff of the Joint Committee on Taxation on June 25, 1987, which would have a negative impact on the retailing industry. With the exception of the comments concerning preservation of the scheduled rate reductions, which we view as of primary importance, the order in which these comments discuss particular revenue options is not intended to reflect the relative priority of each of the options for members of the Retail Tax Committee.

## I. Full Implementation Of The Income Tax Rate Reductions

### A. The Effects of Prior Law

Prior to the 1986 Act, the Internal Revenue Code had become a bewildering array of provisions which benefited specific groups, activities or investments. For more than 20 years, the list of deductions, credits and other special rules had expanded to encourage taxpayers to undertake certain economic activities. These special provisions offered taxpayers the ability to shield income from the burden of high tax rates. The allure of these provisions was so strong that many business executives, individual investors and wage-earning taxpayers were perennially tempted to enter into transactions with limited economic merit because the tax benefits of such transactions were so attractive.

The economic inefficiencies of such tax-motivated decisions became increasingly apparent in the early 1980's. Various media issued reports of overbuilt and underutilized commercial buildings; advertisements promoted "TAX SHELTERS;" professionals who earned substantial incomes from legal tax avoidance schemes proliferated. These trends were the results of efforts to take advantage of provisions to avoid high tax rates.

The exploitation of such legitimate tax-avoidance opportunities began to take its toll in political terms. The news accounts of individual and corporate taxpayers who earned substantial incomes but paid little or no federal income tax were annoying annual reminders of the shortcomings of a system based on high rates and numerous exceptions. Although the top individual tax rate was 50 percent, it is widely believed -- and perhaps accurately so -- that not more than a relative handful of very high income individuals were actually subjected to the top marginal rate. Although large, financially profitable corporations were theoretically subject to the top corporate tax rate of 46 percent, the disparities among effective tax rates was substantial, ranging from 35 percent or higher for a few industries (including retailing in general) to 5 percent or even lower for others.

One increasingly troublesome effect of these news accounts was the lessened confidence of American taxpayers in the fairness and equity of the income tax. For a tax system based on self-assessment by citizens, this growing cynicism was a critical problem. When the tax reform process began in earnest two years ago, one of the principal objectives was to address this potentially devastating compliance problem. The result of that process is a combination of reduced rates and a broader tax base which is producing a system under which taxpayers are much more likely to perceive that a fair share of the federal tax burden is being paid by everyone.

### B. The Effective Tax Rates of Retailers

For many years, the retailing industry has been subject to significantly higher effective tax rates than many other industries because the deductions, credits and other provisions which were of use to our companies were relatively few in number. Therefore, we strongly supported the fundamental features of the tax packages proposed by the President and by this Committee. We were -- and are -- confident that the long-term benefits of an income tax system based on lower rates applied to a broader base outweigh the potential problems associated with short-term, transitional disruptions in business and personal decision-making.

Members of the Retail Tax Committee recognized that such a major overhaul of the income tax system would not have been realized without some painful and unpopular revisions to prior law. Our companies are experiencing the unpleasant results of tax reform along with other industries for which the negative impact of the 1986 Act has been widely publicized.

It is important that this Committee understand that news accounts in recent months have been incorrect in assuming that the retailing industry in general realized a tax reduction under the 1986 Act. In fact, the ten members of the Retail Tax Committee will all pay more federal income taxes for several years under the 1986 Act than under prior law. This increase in effective tax rates for our companies is the result of two changes in tax accounting methods which impact retailing very heavily -- (1) the repeal of the installment method for sales made under revolving credit plans (while other types of installment sales were not affected so harshly), and (2) the enactment of new comprehensive inventory capitalization rules. On average, it will be 1992 or 1993 before reduced tax rates will allow the cumulative income tax burden under the 1986 Act to fall to the level which our companies would have paid under prior law.

### C. The Linkage of Rates and Reforms

As we contemplated the effects of these two accounting changes and other reform features of the legislation, it was explicitly understood by our members -- and, we believe, by taxpayers in general -- that tax reform legislation was developed as a package. The provisions which repealed or revised a number of deductions, credits and other rules were tied to substantial reductions in tax rates. This linkage was necessary for both substantive and political reasons.

The substantive objectives of tax reform -- to reduce the disparities in effective tax rates and to lessen the influence of tax law on economic decisions -- required both broadening the income tax base and reducing tax rates. Absent the rate reductions, the base broadening reform provisions would have imposed crippling tax burdens on the economy, and the intended benefits of tax reform would never be achieved.

Politically, it is widely acknowledged that the ability to adopt legislation in both the House and the Senate was conditioned on lessening the pain of reform with general rate reductions. Absent the rate reductions, it is likely that only a relative handful of proponents of tax reform could have been found either on Capitol Hill or anywhere else in Washington or around the country.

Proposals for delaying or limiting or otherwise diminishing the individual and corporate tax rate reductions ignore the reasons that the reductions were enacted. If any such proposal were allowed to become law, it would produce at least three undesirable results. First, it would limit the long-term benefits which were the primary goals of the 1986 Act. Second, it would break an explicit understanding with taxpayers regarding the reform package and rekindle the cynicism of recent years about federal taxation. Third, it would set in motion the inevitable efforts to reinstate old provisions and to enact new provisions to mitigate the effects of the higher rates.

## II. Surtaxes As Rate Increases

Proposals for imposing surtaxes should not be considered as anything other than tax rate increases by another name and therefore should be disregarded by the Committee. Whether a surtax is imposed on income tax liability after tax credits are claimed, on income tax liability before credits are claimed, on taxable income or in some more exotic manner, the result is the same -- a higher rate of tax is imposed than under the law as now scheduled to go into effect. Therefore, a surtax is simply a less direct means for raising tax rates.

However, a surtax has one other undesirable characteristic; it does not apply uniformly to all taxpayers. Retailers have historically opposed surtaxes because the wide disparities in effective tax rates among different industries would lead to wide disparities in the impact of a surtax. For example, a 10 percent surtax applied to a taxpayer who is subject to a 35 percent effective tax rate produces the equivalent of a 3.5 percent rate increase. However, the 10 percent surtax applied to a taxpayer who is subject only to a 15 percent effective tax rate produces the equivalent of only a 1.5 percent rate increase.

The 1986 Act made significant progress in reducing the gap between high and low effective rates in the corporate community, although our Retail Tax Committee members are not going to benefit from reduced rates for many years. But the gap has not been closed. To impose a surtax would be inequitable and would reverse a portion of the progress made by the 1986 Act.

## III. Limitations On Deductibility Of Advertising Expenses

The revenue options pamphlet includes proposals which would limit the deductibility of advertising costs. We oppose any restriction on the full deductibility of advertising costs in the year they are incurred by retailers. Proposals to limit such deductions are based on a misunderstanding of the functions served by advertising in the ordinary course of conducting a retailing business.

To a very substantial degree, our advertising is designed to apprise consumers immediately of current availability and pricing information concerning specific items or lines of merchandise. Such advertising provides consumers with the comparative information that is vital to the efficient functioning of consumer markets. Absent a steady flow of such information, consumers must either expend their time and resources looking for alternative suppliers of desired goods and competitive prices or, more likely, purchase desired goods from the first retailer they visit who has the goods on hand. Such a lack of price and product information inhibits the consumers' ability to maximize purchasing power and also discourages aggressive competition. Both of these unfortunate results also restrict an economy's ability to grow.

Furthermore, the nature of the retailing business, with profitability depending on high sales volume, requires a continuous flow of current price and product information to maintain the immediate interest of a broad range of potential customers. To suggest that advertising a line of seasonal merchandise in general -- much less a weekend price reduction on specific merchandise such as VCR units -- will produce any benefit/capital asset that has a life which extends beyond a few days or weeks is to fail to understand the purpose of such advertising altogether.

We urge that our advertising costs continue to be deductible in the year in which the costs are incurred. As a matter of tax policy, limiting the current deduction for advertising costs would be an unjustified departure from allowing "ordinary and necessary" expenses of a business to be deducted when computing the income of a retailer. Retail advertising expenditures do not produce a separate and distinct asset which benefits the taxpayer for longer than the year for which income is being computed. Therefore, such advertising costs should be fully deductible in the year the costs are incurred.

## IV. Proposals Relating To Pension Plans

The revenue options pamphlet discusses several proposals which would raise revenue by changing certain requirements for private pension plans. These include a proposal to increase premiums for the Pension Benefit Guarantee Corporation (PBGC) and a proposal to modify the ERISA "full funding limitation," which would effectively reduce the maximum deductible contribution an employer could make to a pension plan.

Retail Tax Committee members, including the members of the National Retail Merchants Association and the American Retail Federation, have approximately 16,000,000 employees. A large number of these employees are covered by defined benefit pension plans and employee benefit programs and would therefore be directly affected by the proposals. Thus, the Retail Tax Committee is highly concerned about proposals which would impact pension plan responsibilities. Specifically, the Retail Tax Committee has adopted three positions with respect to these issues.

First, the Retail Tax Committee supports the concept of a variable premium which would encourage employers maintaining underfunded defined benefit plans to increase the level of plan contributions, thus increasing employee benefit security and reducing the PBGC's potential liability. However, we oppose proposals to increase the "base" premium, which would impose additional costs on employers with no corresponding increase in benefits (i.e., PBGC guarantees) received. Second, while we support the concept of a full funding limitation, we oppose the proposals to redefine the limitation as a multiple of a plan's "termination liability." Such a limit could undermine one of the fundamental policy goals of ERISA, which is to encourage employers to make adequate contributions to provide retirement benefits. Third, we support the Administration's proposal to the extent that it would permit an employer to elect to utilize excess pension plan assets for the purpose of funding retiree medical accounts without requiring the employer to terminate a pension plan and without subjecting the amount withdrawn to an excise tax. This proposal would help ensure that retirees receive needed medical benefits.

## V. Proposals Relating To Employee Benefits

Under current law, an employer may provide certain necessities to employees the value of which is excludable, to some extent, from the employee's income and from wages for purposes of the FICA and FUTA taxes. As listed in the revenue options pamphlet, these "employee benefits" include the provision of: (1) health coverage; (2) group-term life insurance; (3) death benefits; (4) dependent care assistance; and (5) certain meals and lodging for the convenience of the employer. Under certain restrictions, these important benefits may be provided under flexible "cafeteria plans" which permit employees to choose various forms of benefits according to their need. The pamphlet suggests that the beneficial tax treatment accorded these employee benefit systems could be restricted or repealed in order to raise revenue.

We urge the Committee to retain the current tax law treatment of such employee benefits. The current tax treatment encourages creation of employee benefit programs to which employees otherwise might not have access, might overlook or might decide to ignore. An employer's provision to employees of health insurance, life insurance, death benefits and dependent care assistance is an effective and efficient means of assuring that a wide range of employees can afford access to systems of personal and family security which have become necessities in our society.

Another proposal that would have a significantly adverse impact on employees would impose a five percent excise tax on net investment income of all tax-exempt corporations or trusts. Great numbers of employees participate in pension and profit-sharing plans maintained by their employers. Amounts transferred to such plans provide retirement security for many employees in an era when the government retirement system -- social security -- may not be able to provide adequate retirement benefits. Imposing an excise tax on net investment income earned by pension and profit-sharing plans would directly undermine the effectiveness of the private retirement system which has been carefully nurtured by Congress. Therefore, we urge the Committee to protect the efficient and carefully developed private retirement system by not considering any excise tax on the income of qualified trusts established for pension and profit-sharing plans.

## VI. Proposals Relating To Luxury Excise Taxes

The revenue options pamphlet contains proposals which would impose excise taxes on items such as automobiles, boats and yachts, general aviation aircraft, furs, televisions and other electronic entertainment products and jewelry. Several of the proposals include thresholds for application of the excise taxes -- e.g., an excise tax on autos would be imposed only to the extent that the value of an auto exceeds $20,000. The apparent purpose of these thresholds is to limit the impact of the tax to "wealthy" taxpayers. Thus, the pamphlet labels the proposed excise taxes "luxury excise taxes."

We oppose these taxes. As the pamphlet notes, certain excise taxes similar to those proposed were repealed by Congress under the Excise Tax Reduction Act of 1965. The reasons which led Congress to repeal such taxes in 1965 continue to apply in 1987.

For any retail excise tax to raise substantial revenue, it must apply to items which are purchased by a large consumer population, including mostly lower and middle income persons. For example, the pamphlet contains one proposal which would impose a 10 percent tax on the value of consumer electronic entertainment products (including televisions, radios, stereos, VCRs, video cameras and related products). Not surprisingly, this proposal is the only luxury excise tax proposal which would raise substantial revenue -- $7.3 billion over three years. Yet, the burden of such a tax would be borne disproportionately by the many lower to middle income customers who purchase electronic entertainment products such as televisions, radios and stereos. In addition, because these products are sold by many retailers, the costs for both retailing companies and the government of administering such a tax would be substantial.

While the other luxury excise tax proposals generally include thresholds designed to limit the regressive impact of the taxes, it is doubtful that such thresholds accomplish this objective. Even if the regressivity of these excise tax proposals could be limited, the resulting tax would not raise enough revenue to justify the costs for both businesses and the government of administering the tax, which was a principal reason for the repeal of similar excise taxes in 1965.

We urge the Committee to prevent the littering of the federal tax laws with inefficient and unfair "luxury" excise taxes.

## VII. Proposals Relating To The LIFO Method Of Inventory Accounting

The revenue options pamphlet includes proposals which would repeal or penalize the use of the last-in, first-out (LIFO) method of accounting for inventories. We strongly urge the Committee to retain the LIFO method of inventory accounting as provided under current law. The LIFO method has long been accepted as an accurate method of reporting income for financial statement purposes. In fact, as noted in the pamphlet, the LIFO method is considered by many to be the most accurate means of measuring income during periods of inflation.

For example, consider a retailer who sells televisions and whose inventory of televisions grows steadily over a period of years. Under the LIFO assumption, the retailer computes ending inventory for each year by assuming that the televisions sold during any year are the televisions which were most recently purchased from the retailer's supplier. Thus, during a period of inflation, the retailer computes income by charging against gross sales revenues the costs of televisions most recently purchased from the supplier (i.e., televisions purchased at current, or near current supplier prices). If the retailer uses the FIFO assumption during a period of inflation, income would be computed by charging against gross sales revenues the costs of televisions purchased in a prior period when prices of televisions were lower than current prices. Thus, on a continuing basis, the LIFO method more clearly reflects "real" income (i.e., gross revenues at current prices less costs of goods sold at current prices), while the FIFO method reflects inflated or "nominal" income (i.e., gross revenues at current prices less costs of goods sold at prior/lower prices).

Moreover, even if the LIFO method were viewed as some form of tax preference item, current tax law includes a self-enforcing mechanism against aggressive use of the method. The "LIFO conformity requirement" assures that while a LIFO taxpayer may report a lower income for tax purposes, the taxpayer must also report reduced earnings to its shareholders, partners and creditors. Thus, the LIFO conformity requirement operates to prevent aggressive use of the LIFO method for tax purposes. The self-enforcing nature of the LIFO conformity requirement is similar to the rationale behind the alternative minimum tax's "book income preference" which was enacted by the 1986 Act.

## VIII. Federal Unemployment Tax Act (FUTA) Provisions

The revenue options pamphlet includes proposals which would raise revenue from the FUTA tax system. One proposal would index the FUTA wage base. Another would extend the temporary component of the gross FUTA tax rate which was specifically enacted to repay advances from general revenues to the Extended Unemployment

Compensation account. These advances were provided for the sole purpose of financing extended unemployment benefits during a period of massive economic dislocation in the 1970's. The temporary rate component of 0.2 percent is scheduled to expire on January 1, 1988, because the advances were fully repaid in 1987.

We oppose changes to the FUTA tax system in the context of raising general revenues to meet reconciliation revenue targets. The FUTA tax exists for the specific purpose of financing the federal government's responsibilities with respect to the joint federal-state government unemployment insurance program. It should not be subject to the pressures of general federal budgetary demands. Of special concern is the proposal to extend the temporary 0.2 percent component of the gross FUTA tax rate. This extension would not only set an undesirable precedent of the federal government undermining the purposes of the unemployment insurance program for general revenue needs, it would also place an additional burden on payroll taxes as a source of federal revenues. Indexing the wage base would result in continuing additional increases in tax costs.

The result of increased labor costs for labor intensive employers such as retailing companies is almost always a reduction of full- and part-time jobs. Thus, there is a significant risk that the proposed extension of the temporary FUTA rate component and the proposed indexing of the wage base could have the ironic result of causing further unemployment by the very mechanism intended to alleviate the burdens of unemployment. Therefore, we urge the Committee to avoid looking to the FUTA tax system as a means of raising general revenues.

## IX. General Consumption Taxes

One group of proposals which has been presented in the revenue options pamphlet is labeled "General Consumption Taxes" and includes variations of a value-added tax. We believe that consideration of such proposals is not appropriate at this time for two practical reasons.

First, the implementation of any new tax system takes time. The more complex the system, the longer the period during which its rules and regulations should be prepared and then studied by taxpayers. Any broadly-based general consumption tax system would clearly fall into this category. Development and implementation of such a new system in the context of a reconciliation bill which is intended to affect FY 1988 does not appear to be a reasonable possibility.

Second, the potential revenue to be gained from an entirely new system would far exceed the reconciliation requirements for FY 1988 and even for the three-year period FY 1988-1990. Such options would seem out of place in this context.

In addition, the consideration of a new revenue system should be undertaken in a manner which allows a full review of the many problems and economic policy concerns which such a new system would present. Like income tax reform, this would be a lengthy process and could not reasonably be undertaken in the context of reconciliation.

# WRITTEN STATEMENT OF
# SHRINERS HOSPITALS FOR CRIPPLED CHILDREN
# CONCERNING NEW TAXES ON THE NONPROFIT SECTOR

Joint Committee on Taxation Release of
June 25, 1987 (JCS-17-87)

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**REPRESENTING:**

Shriners Hospitals for Crippled Children
2900 Rocky Point Drive
Tampa, Florida 33607

813/885-2575

Dear Mr. Chairman:

This statement is submitted on behalf of Shriners Hospitals for Crippled Children, which operates 20 free hospitals throughout the United States. Our organization is deeply concerned that several staff proposals to raise revenues will do lasting harm to the charitable sector, extract only modest revenues, by government standards, and bring to an end a tradition of support and encouragement for charitable services which Government previously enhanced through its tax policies or by direct financial assistance. In my personal opinion, biased perhaps by long years of service to Shriners Hospitals, taxing its endowment, or that of any other charitable entity, will not serve the larger interests of our Nation or its economy, will effectively de-stabilize many small colleges, community hospitals and social service agencies, and ultimately jeopardize our country's ability to protect its most precious resource, its children.

The hospitals operated by Shriners Hospitals for Crippled are absolutely free. No part of costs of the care and treatment of medically indigent children last year, or for any year, were borne directly or indirectly by the patient, his or her parents or guardian, or by the United States, a state or municipality, or any private or public welfare plan. Last year we treated 14,000 orthopaedic inpatients, 2,000 burns patients and more than 135,000 outpatient visits were recorded.

The $170 million operating budget for 1988, adopted just two weeks ago (which includes $16 million in research) and the additional estimated $30 million construction budget per year, are derived from donations and earnings on our substantial endowment, now approximating $2.5 billion. Because essentially all new gifts and bequests, and capital gains, are added to endowment, our hospital system is prepared for the deluge of the medical needs of crippled and burned children expected by the year 2000.

Several weeks ago we strongly endorsed the Treasury's position that passive investment income spent (or saved) for the public good is in the public interest and should not be taxed.*/ We also emphatically endorsed the concept that charities should not use their tax exemption to acquire, equip, capitalize or subsidize business or commercial enterprises unrelated to the public purpose of the charity. Our research revealed no facts or circumstances, or prospects, for abuse of endowment transactions, since existing law removes almost all exploitation possibilities. Now, however, the staff of the Joint Committee recommends several tax proposals which could cause our charity, and the children we serve, untold and lasting harm.

Here's how several staff proposals would impact on us:

(1) A securities trading excise tax (STET), would tax sales, exchanges and other non-gift transactions for all forms of securities, including securities in endowments owned by charities, based on the sales price. In 1986, we sold some $2.4 billion in marketable securities in the routine re-investment of endowment assets and we purchased an equivalent amount. The excise tax (rate of .005) on securities' sales would cost us at least $12 million annually based on 1986 transactions.

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*/ Statement of O. Don Chapoton (Deputy Assistant Secretary, Tax Policy) on June 22, 1987, before Subcommittee on Oversight of the House Ways and Means Committee.

(2) A five percent federal income tax on net investment income, including interest, dividends and capital gains, is proposed, akin to the two percent tax taxing the investment income of private foundations. In 1986, we earned net income of about $136 million in dividends and interest and realized some $155 million in capital gains. At a .05 rate of tax on this endowment income, an additional $14.5 million in federal tax would be payable, on top of the $12 million STET tax for securities' transactions.

(3) The proposal also includes imposition of an income tax on net appreciation in property passing from a decedent at death, with possible rates being from 28 percent to 33 percent, the income tax rates for 1988. As an alternate, there is a proposal for carryover basis for the appreciated property. The taxation proposal suggests an exemption for transfers to a surviving spouse or charity. Although death time transfers of appreciated property to charity may be exempt, this exemption could always be diluted or repealed, to our detriment, if action is taken on this tax proposal.

Of the $150 million in gifts we received in 1986, about $120 million were gifts at death. Even if only a fourth of the total value of property bequeathed represented the value of appreciation in these gifts, estates of our donors face a jeopardy of some $9 million to $11 million in income tax (using 28 percent to 33 percent as applicable rates). Since all state tax allocation rules on inheritances impose upon the donee the burden of taxation on bequests, a death time capital gains tax (without a charitable exemption) could cost us upwards of $10 million annually, according to our estimates, and possibly much, much more.

(4) One of the proposals suggests the elimination of the current excise tax exemption for telephone taxes now enjoyed by hospitals and schools. At a 3 percent rate of tax, our tax burden from this repeal would be $33,000 based on the $1.1 million phone bill paid in 1986. If the rate of tax went to ten

percent -- which is what it was during World War II, then our costs would increase proportionately.

How do these new taxes impact the operations of our free hospitals? Twenty-five million dollars in new taxes on our hospital system equals the entire operating budgets of four of our smaller hospitals including units located in Honolulu, Houston, Erie and Twin Cities. Nationwide, for our orthopaedic and spinal cord patients, we estimate our out of pocket expenditures (no amortization of plant or equipment) at about $9,000 per admission for orthopaedic cases; and about $6,000 per admission for burns cases (not requiring reconstructive surgery). If we had to pay the federal government $25.0 million in taxes from our operating budget, these taxes can easily be translated into the refusal to admit 3,000 children in need.

The Finance Committee press release indicated that it would focus on all revenue options, including those in the June 25 Joint Committee release. The nonprofit sector is not above accountability through taxation, since it enjoys numerous privileges and immunities which must be borne by the general population. At our request, a Member of the House presented a bill to the Congress in 1984 (H.R. 6388) which contained some selective revenue raising measures -- to balance the revenue costs associated with some charitable contribution incentives we also proposed. In 1986, Congress adopted several of these proposals and we are prepared to think anew with your help about (1) some revenue raising measures which reduce or eliminate abusive situations, (2) balancing revenue needs and social policies, or (3) measures which are keyed to the prevailing desire of the Administration to make users of Government services bear their fair share of incremental costs. We believe this can be done -- but not quickly -- and not without some correlation between the burdens proposed and the value of social services curtailed through tax increases.

Very truly yours,

William J. Lehrfeld

WJL/bb

Smokeless
Tobacco
Council, Inc.

August 11, 1987

Ms. Laura Wilcox
Hearing Administrator
Senate Committee on Finance
205 Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox:

The Senate Committee on Finance is evaluating various methods to create new revenue in an attempt to deal with the federal deficit problem. Some proposals under consideration would increase excise taxes on cigarettes and perhaps on other tobacco products. The Smokeless Tobacco Council, which represents 99 percent of the manufacturers of snuff and chewing tobacco in the United States, urges the Committee to resist any measure which would increase the excise taxes on these items.

## HISTORY OF EXCISE TAX ON SMOKELESS TOBACCO

The smokeless industry became subject to federal excise tax in July of 1986 for the first time in over 20 years. The earlier excise tax on these products was abolished in 1965. For federal excise tax purposes chewing tobacco is now taxed at $.08 per pound, snuff at $.24 per pound. The basis for the level of the taxation implemented in the 99th Congress was to extend the consumer price index from the 1960's rate to the present. The tax generates annually in its entirety about $17.5 million in revenue due to the fact that annual manufacturers' sales are about $850 million. A smokeless tobacco tax, therefore, at any level would be insignificant to the deficit but the effect of increased taxation on the small smokeless industry's revenues would be disastrous. The current year finds consumption of smokeless tobacco products declining appreciably. Growers of these types of tobacco have already complained to Congress about the impact the reduction of demand has had on the farm economies in those areas where the crop is a staple. To again tax these products on the heels of last year's tax is apt to produce even more destructive effects on the small tobacco farmers who depend on it for their livelihood.

## AN INCREASE WOULD BE HARSHLY REGRESSIVE

Excise taxes are naturally regressive and a tax on smokeless items would be particularly hard on those low income consumers who constitute the market. According to the latest available information, one-half of all smokeless users earn less than $25,000 and one half of them earn less than $15,000. About 41 percent of smokeless tobacco consumers are blue collar people for whom this product is one of their few luxuries. Twenty-nine states now tax smokeless products. A half-dozen of these first passed their smokeless tobacco excise tax in 1986, after the renewal of the recently imposed federal excise tax on smokeless tobacco, indicating that states are increasingly looking to smokeless tobacco as a revenue source. Any increase in federal excise taxes would also encroach on an important revenue resource for states.

## AN INCREASE WOULD BE INEQUITABLE AND UNWARRANTED

An excise tax increase on smokeless tobacco would be unduly regressive and would be unduly burdensome to manufacturers and consumers, while raising very little revenue. An increase is therefore unwarranted and should be rejected by your Committee as violative of all accepted standards of tax equity.

I welcome this opportunity to present our industry's views and to assist the Committee in its deliberations. We shall be following your activities on the revenue options with great interest.

Respectfully submitted,

Michael J. Kerrigan

Michael J. Kerrigan
President
Smokeless Tobacco Council, Inc.

MJK:mg

August 17, 1987

## WRITTEN SUBMISSION OF THE STOCK COMPANY INFORMATION GROUP TO THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE CONCERNING AN OPTIONS TO INCREASE REVENUE

The Stock Company Information Group ("SIG") submits this statement for the record of the July 15-17, 1987, hearings of the Committee on Finance concerning options to increase revenue. This statement opposes the adoption of the various proposals to change the taxation of life insurance and annuity contracts, life insurance company reserves, and agents' commissions, as set forth in the June 25, 1987 pamphlet of the Staff of the Joint Committee on Taxation entitled Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means (the "hearing pamphlet"). This statement supports, however, as an way to increase revenue, adoption of the proposal to change the calculation of the "book income" of mutual life insurance companies for alternative minimum tax purposes, as set forth in the hearing pamphlet.

### Introduction

The Stock Company Information Group is a coalition of 28 investor-owned life insurance companies organized in 1981 to monitor tax legislative developments and to convey the views of its membership on life insurance tax issues to the various insurance trade associations and to the Government. The SIG encompasses a majority of the 50 largest stock life insurance companies in the United States, taking into account its members' affiliated companies. The SIG has been privileged to work closely with the Committee and its Staff in connection with the development of the insurance tax provisions as part of the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984 (the "1984 Act"), and the Tax Reform Act of 1986 (the "1986 Act"). A list of SIG members appears at the end of this statement.

Among the revenue-raising options The Committee will examine in seeking to meet its reconciliation instructions under the budget resolution for fiscal year 1988 are several proposals that would radically alter the way owners of life insurance and annuity contracts are taxed and the way that life insurance company reserves and agents' commissions are treated. The SIG believes that these proposals are fundamentally unsound and should be rejected, just as they were previously considered and rejected by Congress. The SIG, therefore supports the joint submission of the American Council of Life Insurance ("ACLI") and the Health Insurance Association of America ("HIAA") in urging that the Committee discard these proposals. The SIG would also have the Committee note that full reconsideration of these and other proposals is currently scheduled, by statute, to occur in 1989 with the aid of formal reports from the Treasury Department. See section 231 of the 1984 Act. Congress chose this more deliberate approach in recognition of the relatively complex, and often inter-related, nature of the items involved. Thus, taking up any of these proposals at this time would at best be premature.

The Committee will also examine a proposal to adjust the manner in which mutual life insurance companies compute their alternative minimum tax liability. The SIG believes that inclusion of this proposal in any revenue package the Committee assembles is particularly appropriate since it not only would raise revenue but also would correct a significant flaw in the new alternative minimum tax enacted as part of the 1986 Act. Indeed, failure to adopt this proposal would sanction the virtual exemption of the mutual life insurers -- including some of the Nation's very largest corporations -- from the new minimum tax rules, contrary to the evident design of Congress.

Part I of this statement discusses the proposals to change the taxation of life insurance and annuity contracts, life insurance company reserves, and agents' commissions and the reasons why the SIG opposes them. Part II discusses the proposal to change the calculation of the "book income" of mutual companies for alternative minimum tax purposes and the reasons why the SIG supports this proposal.

## I. Proposals to Change Insurance Company and Products Taxation

Without repeating all the reasons set forth in the ACLI-HIAA submission, the SIG would like to take this opportunity to record its concerns over the following proposals.

### A. Taxing the "Inside Buildup" of Life Insurance And Annuity Contracts

The hearing pamphlet describes, on pages 221-227, several options that would to a varying extent subject to current taxation the "inside buildup" of life insurance and annuity contracts. Under the most sweeping proposals, the inside buildup on all newly issued life insurance policies, and deferred annuity contracts held by natural persons, would be subject to current tax. More limited variations on these proposals include taxing the inside buildup of single premium life insurance contracts (by changing the tax definition of "life insurance contract") and on deferred annuities with investments exceeding a specified cap. The various proposals, however, all involve the fundamental issue of the propriety of taxing currently the inside buildup of life insurance and deferred annuity contracts.

These proposals, if enacted, would reverse the longstanding recognition that providing financial protection for dependents in case of death through life insurance, and accumulating funds for retirement through deferred annuities, are important social goals that individuals should be encouraged to pursue. Since 1913, the income tax laws have taxed the owner of a life insurance or annuity contract only when certain contract distributions occur, rather than simply as cash values build up. Time and again, Congress, and this Committee in particular, have rejected proposals to tax the inside buildup on such contracts -- most recently in connection with the 1986 Act, and before that when the tax rules for life insurers and their products were comprehensively revised as part of the 1984 Act.

Instead, Congress has appropriately chosen to refine the relevant provisions of the tax law so that the current treatment would be confined to those life insurance and annuity contracts that are used in a manner consistent with the intent of Congress underlying that treatment. Thus, in each of the 1982, 1984, and 1986 Acts Congress amended the tax rules to ensure that only those life insurance contracts designed to provide death benefit protection, and only those amounts accumulated under deferred annuities to provide for future retirement, would be accorded the historic treatment.

At odds with this more deliberate, studied approach taken by Congress, these proposals would have the Committee again consider what it has firmly rejected in the past. One of the proposals, for example, would have the Committee consider a precipitous and yet significant change in the carefully crafted, highly complex definition of life insurance enacted in 1984 and amended in 1986. The proposal, apparently reasoning that paying for a life insurance policy with some unspecified number of premiums is (magically) sounder than paying for it with fewer premiums, would have the Committee quickly change a statute which required a joint undertaking of Congress, the Treasury Department, and numerous industry representatives over three years to develop. If any provision of the tax law needed to be reviewed on a careful, unhurried basis, in keeping with the approach contemplated by section 231 of the 1984 Act, surely it is the definition of life insurance.

Quite apart from the fact that Congress has appropriately rejected proposals such as these in the past, these proposals contradict basic tax principles. In particular, under the long-standing doctrine of constructive receipt, potentially taxable gains that are "locked up" in property, and thus are not reducible to cash without the surrender of valuable rights in that property, do not properly constitute income currently subject to tax. Congress naturally has been hesitant to levy a tax on "income" that only theoreticaly exists in a taxpayer's hands, since the tax must be paid with cash rather than with theories. Taxing currently gains locked up inside a life insurance or annuity contract, as these proposals aim to do, would significantly raise the cost of obtaining insurance protection or retirement security and thus greatly discourage individuals form purchasing such contracts. The SIG, therefore, strongly urges the Committee once again to reject these proposals.

B. Changing the Treatment of Life Insurance Reserves

The hearing pamphlet describes, also on pages 221-227, several options that would change the way life insurance companies treat their reserves for tax purposes. One option, for example, proposes to prohibit life insurance companies from deducting increases in reserves for newly issued life insurance and annuity contracts, confining them solely to deducting amounts when benefits are paid. Another option proposes to prohibit such a reserve deduction to the extent the reserve exceeds the cash surrender value of a contract.

These proposals run contrary to over 70 years of tax policy and practice. Life insurance companies have always been allowed a deduction from taxable income for any net increase in life insurance reserves, and must include in income any net decrease in those reserves. This historic treatment reflects a recognition of the long-term nature of life insurance, annuity, and noncancellable and guaranteed renewable accident and health insurance contracts -- many of which have no cash values -- which cannot be accounted for with simplicity on an annual basis other than by means of a reserve method. Congress and state insurance regulators long ago came to understand this, and Congress in particular has provided the tax rules that it has for life insurers to ensure that their income and deductions are properly matched.

Adoption of the proposals would contradict this historical pattern and result in a serious mismatching of income and expenses. Ironically, it would place life insurance companies, which by tax statute and state regulation report on an accrual basis, on a cash receipts and disbursements method of accounting for Federal income tax purposes, even as the tax law has moved decidedly in the direction of requiring others to use the accrual method in determining tax liability. For these and other reasons, all such proposals should again be discarded.

C. Treating the Reserve Deduction as a Tax Preference

The hearing pamphlet, on page 224, describes an option under which the deduction a life insurance company takes for life insurance reserves would be treated as an item of tax preference under the new alternative minimum tax. Classification as a tax preference, however, typically is reserved for those instances where special tax treatment representing a departure from settled tax policy is accorded to select persons or transactions. The deduction for life insurance company reserves, however, is a cornerstone of insurance company taxation, which has existed in one form or another since 1913. As just discussed, this historic treatment reflects a recognition that the contracts for which these reserves are held are long-term in nature, and a deduction for reserves is necessary to avoid a severe mismatching of income and expenses. It is difficult to understand the basis for this proposal, beyond the bald fact that it raises revenue. The SIG, therefore, urges its rejection.

### D. Capitalization of Agents' Commissions

As a final matter, the hearing pamphlet describes, on pages 238-239, an option under which a life insurance company would be required to capitalize the agents' commissions it pays as an expense of earning premium income and to amortize them over a certain period. As is the case with many of the proposals considered so far, this proposal was carefully considered and rejected by Congress in its comprehensive revision of life insurance company taxation under the 1984 Act.

The principal justification offered for the proposal is that capitalization is necessary to limit for tax purposes an apparent mismatching of income and expenses, since agents' commissions are deductible in determining an insurer's gain or loss from operations on its annual statement. But, as the hearing pamphlet itself acknowledges, this overlooks (among other things) the fact that well-settled tax accounting principles fully support the current treatment of agents' commissions, particularly since these expenses are completely accrued for tax purposes. It also overlooks the fact (as, again, the hearing pamphlet acknowledges) that the method applicable in determining of life insurance reserves deductible for tax purposes under section 807(d) of the Internal Revenue Code -- the Commissioners Reserve Valuation Method -- is a preliminary term method which forgoes initial reserve deductions in order to provide for the expensing of policy acquisition costs (including agents' commissions) in a manner that limits any mismatch of income and expenses. Congress acknowledged this just last year when it declined to extent the 20 percent unearned premium "cutback" to life insurance reserves included under section 832 of the Code, reasoning that this was appropriate "because such life insurance reserves are calculated under sec. 807 in a manner intended to reduce the mismeasurement of income resulting from the mismatching of income and expenses." S. Rep. No. 99-313, 99th Cong., 2d Sess. 496 (1986). The SIG, therefore, once again urges the Committee to reject this proposal.

## II. Proposal to Amend the Minimum Tax Rules

### A. Background: The Treatment of Policyholder Dividends

A life insurance company may be organized in one of two different forms: it may be a stock company or it may be a mutual company. A stock life insurance company is owned by its shareholders, whereas a mutual life insurance company is owned by its policyholders. A policyholder of a mutual company is thus both an "owner" and a "customer" of the company (see H.R. Rep. No. 98-432, pt. 2, 98th Cong., 2d Sess. 1422 (1984)).

When a stock life insurer pays dividends to its shareholders, it is clear that the amounts so distributed consist of corporate-level earnings -- earnings which should be subjected to Federal income tax. And, indeed, that tax is imposed on the stock company's corporate-level earnings, when they are realized and again when they are distributed to the company's shareholders. Shareholder dividends are not deductible by any corporation (including a stock life insurer) in determining its taxable income.

When a mutual life insurer pays dividends to its policyholder-owners, on the other hand, it is not clear what portion of those dividends is paid to policyholders in their capacity as owners of the enterprise, and what portion is attributable to their role as customers. If these portions were directly determinable, it would undoubtedly follow that for Federal tax purposes, the ownership portion of the dividends would not be deductible by the mutual company in computing its taxable income, while the customer portion would be deductible. In other words, from the mutual company's standpoint, only a limited amount of its dividends would be deductible.

Unfortunately, the portion of a mutual life insurer's dividends attributable to the ownership role of its policyholders is not determinable by any direct, precise means. Mutual companies have never distinguished between these two elements of their dividends, apparently having neither means nor motivation to do so. Thus, in writing the tax laws over the years, Congress has used approximations to arrive at the ownership-related, and nondeductible, portion of a mutual life insurer's policyholder dividends. In the most recent revision to the taxation of life insurance companies enacted as part of the 1984 Act, Congress adopted current sections 808(c)(2) and 809 of the Internal Revenue Code (the "Code") to reduce the amount of policyholder dividends that mutual life insurers could otherwise deduct. This reduction is in an amount approximating the portion of total dividends representing a return to policyholders in their capacity as owners. In this fashion, as under predecessor enactments dating back to the inception of the modern corporate income tax, Congress has preserved in the tax base of mutual life insurers their corporate-level earnings in excess of customer distributions.

Thus, the limitation on the deduction a mutual life insurer may claim for the policyholder dividends it pays or accrues, as found in current sections 808(c)(2) and 809, is fundamental to the life insurance company tax rules and, indeed, to the entire corporate income tax law. Without such a limitation, a mutual life insurer would be able to remove from its Federal tax base the corporate-level earnings it returns to its owners, a privilege not accorded to any other corporation. With respect to stock life insurers in particular, the failure to impose such a limitation on mutual life insurers would place stock life insurers at a tax-induced competitive disadvantage in a life insurance marketplace occupied by virtually tax-exempt mutuals.

As part of the 1986 Act, Congress imposed on corporations an alternative minimum tax intended "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits." S. Rep. No. 99-313, 99th Cong., 2d Sess. 518 (1986). The base for this new alternative minimum tax is a corporation's regular taxable income (with certain modifications) increased by its "tax preferences." One of these preferences is the "book income preference," which requires a corporation to add to its minimum tax base 50 percent of the excess of its "adjusted net book income" over its "alternative minimum taxable income." Adjusted net book income, for this purpose, means the net income or loss reported by a corporation on its "applicable financial statement," subject to certain adjustments. The book income preference based on adjusted net book income applies only with respect to taxable years beginning in 1987, 1988, and 1989. For taxable years beginning after 1989, this preference is replaced by a preference based on a corporation's "adjusted current earnings," rather than its adjusted net book income.

In calulating adjusted net book income for the 1987-1989 taxable years, the applicable financial statement for any mutual life insurance company is its annual statement, a formal accounting report which all life insurers are required to file with state regulators. The annual statement, however, contains two potentially relevant statements of income: gain or loss from operations _without_ a deduction for policyholder dividends, and gain or loss from operations _with_ a deduction for policyholder dividends. The statute does not specify the use of either of these income statements, nor does it give any indication of the extent to which policyholder dividends are to be taken into account in computing the adjusted net book income of a mutual company. The Conference Report on the 1986 Act, however, states that "the conferees intend that the measure of pre-tax book income is the amount of net gain from operations after dividends to policyholders and before Federal income taxes." H.R. Rep. No. 99-841, vol. II, 99th Congs., 2d Sess. 273 (1986).

Thus, giving effect to the language of the Conference Report, the adjusted net book income of a mutual company will be reduced by all policyholder dividends, contrary to the rule in the regular tax base under sections 808(c)(2) and 809. Consequently, the amount of the book income preference for a mutual company will be considerably lower than if a deduction for policyholder dividends were not allowed in full. In contrast, the adjusted net book income for a stock life insurance company (whether measured by its annual statement or otherwise) will necessarily include all of its shareholder dividends, since no permission is given to deduct any portion of these.

For taxable years beginning after 1989, when the preference based on adjusted current earnings takes effect, this disparity in treatment between mutual and stock companies (and between the regular and minimum tax bases) is eliminated by reinstituting the effect of the limitation under sections 808(c)(2) and 809. Thus, as explained in the Joint Committee's _General Explanation of the Tax Reform Act of 1986_ (on page 457):

> In general, adjusted current earnings requires the same treatment of an item as used for purposes of computing unadjusted alternative minimum taxable income [the regular tax base]. Thus, for example, deduction disallowances or limitations that apply for purposes of determining regular taxable income and alternative minimum taxable income also apply for purposes of determining adjusted current earnings (e.g., the disallowance of a deduction for bribes and kickbacks (sec. 162(c)) or for penalties (sec. 162(f)), and the limitation on the deduction for policyholder dividends (sec. 808(c)(2)).

### B. _Need for a Correction_

As suggested in the hearing pamphlet on pages 234-235, in computing the book income preference a mutual life insurance company should not have the benefit of a full deduction for the amount of policyholder dividends. Rather, the dividend deduction limitation of sections 808(c)(2) and 809 of the Code that applies in determining regular taxable income should apply in determining adjusted net book income during 1987-1989. It is a striking anomaly that mutual life insurance companies are denied a full deduction for policyholder dividends for regular tax purposes but are allowed this benefit in computing the book income preference for alternative minimum tax purposes. This is a reverse tax preference! The aberrant nature of this treatment is further exposed by the fact that, after 1989, the preference based on adjusted current earnings will clearly preclude the benefit of a full deduction.

And it is perhaps even more anomalous that the full dividend deduction allowed to mutual life insurers during 1987-1989 operates virtually to exempt them from the minimum tax. This result, which the book income preference was intended to help prevent, is due to the full deductibility of policyholder dividends accorded to mutual companies.

The preferential treatment of mutual life companies during the 1987-1989 under the book income preference is obviously nothing more than a tax expenditure, and a most improper one.

### C. The Proposal

Accordingly, the book income preference should be corrected to preclude mutual life insurance companies from benefiting from a full deduction for policyholder dividends in calculating adjusted net book income. Specifically, mutual life companies should only be allowed a deduction for policyholder dividends in determining adjusted net book income to the extent they represent distributions to policyholders in their capacity as customers, and not to the extent they represent a return to policyholders as owners. Since sections 808(c)(2) and 809 of the Code were intended to accomplish this for regular tax purposes, and after 1989 will be employed to accomplish this for minimum tax purposes, the book income preference for 1987-1989 should be amended to permit a mutual life company's deduction for policyholder dividends only to the extent permitted by those sections. This could be done by altering section 56(f)(2) of the Code to specify that a mutual life insurance company, in computing its adjusted net book income, may deduct policyholder dividends only to the extent allowed under section 808(c)(2) (incorporating the rules of section 809) in computing life insurance company taxable income.

Enactment of this proposal would not only correct a significant flaw in the new alternative minimum tax, but would also raise revenues. In the hearing pamphlet, the Staff of the Joint Committee estimated that, over a three-year period, enactment of the proposal would raise at least $100 million in additional revenues. Although this is not an insignificant amount, the SIG has reason to believe that this figure substantially understates the potential revenue that would be raised. Rather, based on the best information currently available, the SIG estimates that the proposal's enactment would produce at least an additional $100 million per year. In the interest of obtaining a more accurate quantification of the proposal's revenue impact, representatives of the SIG stand ready to meet with members of the Staff of the Joint Committee to discuss the matter further.

## III. Conclusion

In summary, the SIG fully supports the ACLI-HIAA submission and urges the Committee to reject the proposals to change the taxation of life insurance and annuity contracts, life insurance reserves, and agents' commissions, as well those proposals not specifically mentioned above which are addressed in the ACLI-HIAA statement. The SIG, however, strongly supports the adoption by the Committee of the proposal to change the way "book income" is calculated by mutual life insurance companies for alternative minimum tax purposes. The SIG believes that the current book income preference, as applied to mutual life insurance companies, is flawed and undermines the purpose of the new alternative minimum tax. Moreover, correcting this flaw will raise a not insignificant amount of additional revenue.

The member companies of the SIG wish to thank the Committee on Finance for the opportunity to comment on this matter.

Respectfully submitted,

DAVIS & HARMAN

by: William B. Harman Jr
William B. Harman, Jr.
for
The Stock Company
Information Group

## MEMBERS OF THE STOCK COMPANY INFORMATION GROUP

Aetna Life & Casualty Company
Allstate Life Insurance Company
American General Corporation
Business Men's Assurance Company of America
Capital Holding Corporation
CNA Insurance Company
CIGNA Corporation
Federal Kemper Life Assurance Company
Federal Home Life Insurance Company
Franklin Life Insurance Company
Hartford Life Insurance Company
E.F. Hutton Life Insurance Company
ICH Corporation
IDS Life Insurance Company
Integon Life Insurance Corporation
Jefferson-Pilot Life Insurance Company
Monarch Capital Corporation
Liberty Life Insurance Company
Life Insurance Company of Georgia
Life Insurance Company of Virginia
Lincoln National Life Insurance Company
Paul Revere Life and Accident Insurance Company
Provident Life and Accident Insurance Company
Torchmark Corporation
Transamerica Occidental Life Insurance Company
Travelers Insurance Company
Unum Corporation
Washington National Insurance Company

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RICHARD S. WHITE, JR.
First RepublicBank Corporation
Dallas

July 10, 1987

Laura Wilcox
Hearing Administrator
Committee on Finance
U.S. Senate
205 Senate Dirksen Office Building
Washington, D.C. 20510-6200

Dear Laura Wilcox:

The Texas Bankers Association Trust Financial Services Division is submitting these comments on the impact of the "Repeal of the 'Stepped-up Basis' Rule" revenue option. The Association represents more than 300 bank trust departments that offer fiduciary services in the Southwest.

Carryover basis became law in 1976 and was repealed in 1980 because Congress recognized that it does not and cannot be made to work. Carryover basis is a tax on unrealized capital gains at death. While it may have conceptual appeal, it has a fatal flaw: it depends on accurate records of when an asset was acquired and for how much. The problem is that people do not always keep records. Let's look at three examples presented in 1979 testimony to the Ways and Means Committee:

1. One bank reported that in approximately 99% of its estates, no basis could be located for chattels;
2. A Philadelphia lawyer reported of a case with 1,700 items valued at $4.7 million and after four months of effort to ascertain basis, he still did not know the basis of three-quarters of the items; and
3. One Mississippi bank referred to an estate valued at $216,000 of which $171,500 was attributed to 6,533 shares in a corporation. The decedent inherited 7 shares from her husband's estate and later the stock changed as a result of 11 stock dividends, 11 sales, 4 stock splits and 5 mergers or acquisitions. The bank was unable to determine the cost basis of the stock.

Laura Wilcox
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In addition to the difficulty of proving basis, there is the complexity of carryover rules. Under the 1976 law, several complex adjustments to basis were required to take into account federal estate taxes. Sometimes years pass before these are finally determined. As a result, income tax returns reporting sales of inherited property filed by heirs prior to the final determination of the death tax liability would have to be reopened and the tax recomputed. With carryover basis, amended income tax returns and refund claims would be common.

The third reason to oppose carryover basis is the resulting excessive taxation on estates when the estate tax, the estate income tax, and a second income tax on gains are combined resulting in severe liquidity problems.

In summary, carryover basis should be avoided because it does not work. It is difficult to prove basis; carryover basis is too complex; and the result is excessive taxation.

We appreciate the opportunity to comment on this revenue option. We urge the Committee to oppose its implementation.

Sincerely,

Scott A. Blech
Executive Director

SAB/kt

copy: The Honorable Lloyd Bentsen

# STATEMENT OF ALLEN F. JACOBSON
## CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER
## 3M COMPANY

## INTRODUCTION -- 3M'S PERSPECTIVE

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE:

MY NAME IS ALLEN JACOBSON. I AM CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER OF 3M.

I'M HERE TO URGE THAT WE COMPLETE, ON SCHEDULE, THE JOB OF TAX REFORM WE BEGAN LAST YEAR. TO PUT OUR POSITION IN PERSPECTIVE, LET ME TELL A LITTLE ABOUT THE KIND OF COMPANY WE ARE.

3M IS A HIGHLY DIVERSIFIED INTERNATIONAL COMPANY WITH SALES LAST YEAR OF $8.6 BILLION.

3M HAS OPERATIONS IN 35 STATES AND IN 49 COUNTRIES AROUND THE WORLD. WE HAVE 81,000 EMPLOYEES WORLDWIDE, INCLUDING ABOUT 48,000 PEOPLE IN THE UNITED STATES.

WE ARE A MANUFACTURING COMPANY.

YOU MAY KNOW US PRIMARILY FOR OUR CONSUMER BRANDS:

- SCOTCH BRAND TAPES AND VIDEOCASSETTES
- AND POST-IT BRAND REPOSITIONABLE NOTES.

BUT IN THE GREAT MAJORITY OF OUR BUSINESSES, WE SERVE INDUSTRIAL AMERICA, WITH PRODUCTS LIKE:

- COATED ABRASIVES -- WHICH YOU MAY CALL SANDPAPER
- CONNECTING AND TESTING EQUIPMENT FOR TELEPHONE SYSTEMS
- SYSTEMS FOR CONNECTING ELECTRONIC CHIPS TO THE OUTSIDE WORLD
- AND MANY OTHER PRODUCTS.
- WE PRODUCE A TOTAL OF 50 THOUSAND PRODUCTS, USING 100 TECHNOLOGIES.

WE HAVE A STRONG COMMITMENT TO RESEARCH . . . TO THE DEVELOPMENT OF NEW PRODUCTS . . . AND TO

STEADY GROWTH AND THE CREATION OF NEW OPPORTUNITIES.

WE ARE A POSITIVE CONTRIBUTOR TO THE UNITED STATES' POSITION IN WORLD TRADE. 3M IS THE 33RD-LARGEST EXPORTER IN THE UNITED STATES. WE EXPORT MORE THAN TWICE THE DOLLAR VALUE OF WHAT WE IMPORT, AND OUR EXPORTS ARE GROWING. OUR EXPORTS IN THE FIRST HALF OF 1987 INCREASED 11.8 PERCENT.

WITH THE HELP OF THE NEW TAX LAW AND THE MORE PROPERLY VALUED DOLLAR, WE ARE GAINING MARKET SHARE IN OUR OVERSEAS MARKETS. ON THE AVERAGE, WE HAVE BEEN ABLE TO LOWER OUR SELLING PRICES . . . AND THAT IS CONTRIBUTING TO OUR GROWTH IN SALES.

IN ADDITION, WE BRING INTO THE COUNTRY A STEADY FLOW OF DIVIDENDS AND FEES FROM OUR OVERSEAS OPERATIONS.

BECAUSE WE ARE A PROFITABLE GROWTH COMPANY . . . WE PAY A SUBSTANTIAL TAX BILL. IN

THE LAST FIVE YEARS, IN THE UNITED STATES, OUR COMPANY'S FEDERAL AND STATE CORPORATE INCOME TAX EXPENSE TOTALED $1.6 BILLION. THAT'S A TAX RATE OF 40 PERCENT OVER THE FIVE-YEAR PERIOD.

## STIMULATING GROWTH, COMPETITIVENESS, EFFICIENCY

NOW, GIVEN OUR POSITION AS A GROWTH COMPANY . . . AS A RESEARCH COMPANY . . . AS A POSITIVE CONTRIBUTOR TO THE U.S. TRADE PICTURE . . . HOW DO WE FEEL ABOUT THE TAX REFORM ACT OF 1986?

WE SUPPORT IT. WE THINK IT HAS ALREADY BEGUN TO STIMULATE GROWTH IN COMPANIES SUCH AS 3M . . . IN OUR CASE, GROWTH IN OUR DOMESTIC, EXPORT AND INTERNATIONAL BUSINESS.

LET ME TELL YOU WHAT IT'S STARTING TO ACCOMPLISH FOR THE ECONOMY.

FIRST, THE REDUCTION IN THE CORPORATE RATE FROM 46 PERCENT TO 34 PERCENT WILL GIVE US AND

SIMILAR COMPANIES ADDITIONAL FUNDS TO INVEST IN WORKING CAPITAL . . . IN EQUIPMENT, RESEARCH AND DEVELOPMENT. THIS REDUCTION IN RATE IS THE MOST POSITIVE ELEMENT IN TRA '86. WE THINK IT WILL BE A STIMULANT FOR ECONOMIC GROWTH.

SECOND, COMPETITIVENESS.

REDUCTION IN THE CORPORATE TAX RATE WILL MAKE US MORE COMPETITIVE IN WORLD MARKETS.

DURING THE PAST YEAR . . . BECAUSE OF INCREASED MANUFACTURING EFFICIENCY . . . WE'VE BEEN ABLE TO DECREASE THE MANUFACTURING COST COMPONENT OF OUR EXPORTS BY THREE PERCENT. WE INCREASED EXPORTS IN DOLLAR VALUE BY 11.8 PERCENT.

I THINK THAT'S COMPETITIVENESS.

IN ADDITION, THE CORPORATE TAX RATE OF 34 PERCENT IS SHIFTING INCENTIVES . . . FROM INVESTING OUTSIDE THE U.S. . . . TO MANUFACTURING INSIDE THE U.S. . . . AND EXPORTING THE PRODUCTS.

WE NEED SOME STABILITY IN TAX RATES TO PLAN THESE LONG-TERM INVESTMENTS.

AT 3M, OUR 1986 CAPITAL EXPENDITURES IN THE U.S. WERE $500 MILLION. IN 1987, THEY ROSE 10 PERCENT TO $550 MILLION. AND NEXT YEAR, WE EXPECT THEM TO REACH $600 MILLION.

I THINK THAT SHOWS THERE IS LIFE WITHOUT INVESTMENT TAX CREDITS. LIFE BASED ON GROWTH AND LOWER TAXES ON PROFITS.

RESEARCH AND DEVELOPMENT EXPENDITURES WERE $564 MILLION LAST YEAR . . . UP 70 PERCENT FROM FIVE YEARS AGO, AND CONTINUING TO GROW.

THIRD AND FINALLY, REDUCING CORPORATE TAX RATES AND TAX INC~~ENTIVE~~S AT ~~THE SAME TIME~~ HAS ACCOMPLISHED ~~A NUMBER OF~~ THINGS.

IT MAKES TAX-AVOIDANCE CONSIDERATIONS A SMALLER FACTOR IN BUSINESS DECISIONS.

IT PUTS ALL INDUSTRY ON A MORE EQUAL FOOTING UNDER OUR TAX LAWS.

AND IT REQUIRES BUSINESSES TO PICK UP A LARGER SHARE OF MANY BUSINESS EXPENSES . . . AND REDUCES THE GOVERNMENT SHARE OF THOSE EXPENSES. IN OUR EXPERIENCE, THIS FACTOR IS ALREADY LEADING TO GREATER COST CONTROL AND IMPROVED EFFICIENCIES IN AMERICAN BUSINESS.

## EFFECT ON INDIVIDUALS

I'VE BEEN TALKING ABOUT CORPORATIONS, OR MORE SPECIFICALLY 3M. NOW I WANT TO SAY A WORD ABOUT INDIVIDUAL MEN AND WOMEN . . . AND HOW THEY'RE AFFECTED BY TAX REFORM.

I SAID A LITTLE EARLIER THAT 3M IS A RESEARCH COMPANY. OUR GOAL IS THAT 25 PERCENT OF OUR SALES EACH YEAR COME FROM PRODUCTS NEW IN THE LAST FIVE YEARS. AND WE ARE MEETING THAT GOAL.

WHERE DO ALL THESE NEW PRODUCTS COME FROM?

THEY COME FROM PEOPLE:

- PEOPLE WHO ARE SKILLED AND INTELLIGENT
- PEOPLE WHO ARE MOTIVATED
- PEOPLE WHO ARE ENTREPRENEURS WITHIN THE CORPORATION
- PEOPLE WHO DERIVE THEIR INCOME . . . NOT FROM DIVIDENDS OR CAPITAL GAINS . . . BUT FROM SALARY.

I FIRMLY BELIEVE THAT REFORM OF PERSONAL TAX RATES HAS ALREADY HAD AN EFFECT ON PEOPLE'S MOTIVATION. I CAN TELL YOU: SINCE THE BILL WAS PASSED, I'VE HEARD MORE PEOPLE TALKING ABOUT IMPROVING THEIR INCENTIVE PAY THROUGH PERFORMANCE . . . AND FEWER PEOPLE TALK ABOUT SHELTERING THEIR INCOME.:

SO THE REAL BENEFIT FROM WHAT YOU'VE ACCOMPLISHED WITH TAX REFORM IS NOT JUST LEAVING

MORE MONEY IN PEOPLE'S POCKETS. IT'S MOTIVATING THEM: LETTING THEM:

- SHOOT FOR THE SKY IF THEY WANT TO
- AND RETAIN A LARGER SHARE OF THE BENEFITS
- AND IN THE PROCESS, CREATE ECONOMIC OPPORTUNITY.

I THINK WE'RE BEGINNING TO SEE SOME EFFECTS ALREADY.

LAST YEAR IN OUR COMPANY, 30 NEW BUSINESSES OR PRODUCT LINES REACHED THE $2-MILLION MARK IN SALES . . . UP BY MORE THAN ONE-THIRD OVER THE YEAR BEFORE.

IN THE FIRST SIX MONTHS OF THIS YEAR, WE HAD A 32 PERCENT INCREASE IN PATENT APPLICATIONS.

I WANT OUR PEOPLE TO SHOOT FOR THE SKY. I WANT THEM TO DO THEIR LEVEL BEST . . . FOR THEIR

COMPANY . . . FOR THE ECONOMY . . . AND FOR THEMSELVES.

REFORMING PERSONAL TAX RATES WAS A BIG STEP IN THIS DIRECTION. I HOPE THAT YOU'LL GIVE REFORM A CHANCE TO WORK.

## GIVE TAX REFORM A CHANCE

SO IN SUMMARY, WE BELIEVE THAT THE TAX REFORM ACT OF 1986 IS:

- A STIMULANT FOR INDUSTRIAL EFFICIENCY
- A STIMULANT FOR PERSONAL PERFORMANCE
- AND A STIMULANT FOR ECONOMIC GROWTH IN OUR DOMESTIC AND INTERNATIONAL BUSINESS.

WE VIGOROUSLY URGE YOU TO LEAVE IT IN PLACE, UNCHANGED, UNTIL WE CAN SEE ITS FULL IMPACT.

TO STAY COMPETITIVE, [illegible] ~~INDUSTR~~Y NEEDS TO BE ABLE TO MAKE LONG-RANGE PLANS. AND THAT MEANS WE NEED A STABLE TAX SYSTEM.

WE BELIEVE THAT, OVER TIME, TRA '86 WILL HELP

PRODUCE A COMPETITIVE, PROSPEROUS AND EXPANDING MANUFACTURING BASE IN THE UNITED STATES . . . A MANUFACTURING BASE ESSENTIAL TO OUR FUTURE.

I RESPECTFULLY ASK THAT YOU GIVE THE TAX REFORM ACT OF 1986 A CHANCE TO DO THE JOB IT WAS DESIGNED TO DO.

###

## Statement of Dr. T. Carlton Blalock, Executive Vice President
## The Tobacco Growers Association of North Carolina, Inc.
## Presented to
## United States Senate Committee on Finance

I am T. Carlton Blalock, Executive Vice President of the Tobacco Growers Association of North Carolina, Inc. My organization represents both burley and flue-cured tobacco farmers in the state, and our basic goal is to speak for the active tobacco grower.

For the active grower, there is no question about the effect of increasing federal excise taxes on cigarettes: It will be disastrous. As most of you on this committee are aware, growers went through years of turmoil and economic decline until a comprehensive reform of the federal tobacco program was finally signed into law in April of 1986.

Since it was signed, we have seen modest signs of recovery. Our 1986 markets saw a reduction from the previous year in the amount of tobacco failing to find a buyer, and for many farmers there was a small increase in their net profits from the 1986 crop.

If Congress doubles the federal excise tax on cigarettes, all that progress will go up in smoke, and I predict that many of the farmers who were able to successfully stave off bankruptcy two years ago will fall victim to it now. The rural economy in our state will be devastated, a prediction I can make with certainty, because we've been through this before. When the excise tax was doubled in 1982, consumption went down, the offtake from our markets was drastically curtailed, loan takes were increased, quotas were cut and assessments on farmers reached double digits. If this happens again, tobacco farmers will feel--and I believe justifiably so--that they have again been misled by their leaders.

Please remember that tobacco farmers do not get a government subsidy as do the producers of many commodities. We believe, in fact, that we can make a very good case that tobacco farmers subsidize government.

Sales and excise taxes (excluding local taxes) already equal 40 percent of consumer expenditures on cigarettes. That's considerably more than the farmer gets! In 1986, a grower received an average of 50 cents per tobacco plant. The federal excise tax generated from that one tobacco plant, meanwhile, amounted to 86.4 cents based upon the current federal tax of 16 cents per pack, while the average state tax of 17 cents per pack amounted to 91.8 cents. That's a total of $1.78 per plant for state and federal taxes and it doesn't even consider local taxes. Let me tanslate that into terms of acre value. The grower in 1986 got a gross of $3,040 for one acre of tobacco. That same acre generated $10,680 in state and federal taxes, $5,184 in federal excise taxes alone! The U.S. government is already collecting more than 3.5 times as much revenue per acre as the farmer does. Isn't that enough, we ask?

Remember, too, the farmers pay the cost of the price support program. Since 1982, tobacco farmers have been required to pay an assessment to operate their program and assure the federal government that it will incur no loss. In 1985, this assessment reached 25¢ for every pound of tobacco the farmer grew, or the equivalent of $500/ acre! The President of our Association that year grew 100 acres of tobacco. His assessment amounted to $50,000. It became the straw that almost "broke the camels back." He sold his home and he almost lost his farm. As you can imagine, he becomes incensed when the media talks about "the tobacco subsidy". Under this new program, however, he's going to make it. His land values have gone back up. His quota is worth twice what it was in 1985 and the financial institutions are willing to loan him operating money in 1987. He's but one exampple of thousands of others just like him in our state.

On behalf of our members, we plead with you to reject any proposed increase in the federal cigarette excise tax. It will negate the bipartisan effort of Congress when it passed the Tobacco Reform Act of 1986. You will destroy the delicate balance between supply and demand that we're beginning to achieve under this new program. In so doing, you will also take away the new stability we've achieved in the past twelve months in this industry and once again dash the hopes of tobacco farmers that they can see a return to profitability on their farm. Tobacco is one segment of our agricultural economy where we have been able to turn things around as a result of action by the Congress. It makes little sense, to our members in particular, for this same Congress to take action that will certainly wipe out all of these gains and force us to again look for ways in which our federal government can offer some relief to tobacco farmers.

**ROBERT D. TOLLISON**
2515 N. BUCHANAN ST.
ARLINGTON, VIRGINIA 22207

**Statement of**
**Dr. Robert D. Tollison**
**Professor of Economics**
**George Mason University**

**Before the Senate Committee on Finance**
**United States Senate**
**July 16, 1987**

My name is Dr. Robert D. Tollison. I am a Professor of Economics at George Mason University. In the first term of the current Administration, I served as Director of the Bureau of Economics of the Federal Trade Commission. Over the course of my career as an economist, I have written about two hundred research papers in academic journals, and written or edited over a dozen books. In recent years, I have devoted much attention to the economics of social cost, an area in which I have written and published numerous articles, as well as a major study entitled Smoking and Society (Lexington Books, 1986).

I am here today to testify about proposed increases in the Federal excise tax on cigarettes. More specifically, I would like to speak to the so-called "social cost" or "user fee" rationale that has been advanced by some advocates of such a tax increase. As a professional economist, I find such arguments very confusing and rife with economic error, made worse by the cloaking of these arguments in impressive sounding economic jargon. But a bad argument is a bad argument no matter how you draw it up. I will outline these mistakes in turn.

At base, all of the discussion about the supposed need for increased rates of tobacco tax assumes that smokers create large costs for others in society, and ought to be made to pay for these costs. This argument is often made in relation to health care costs. Smokers who get sick require medical care. Therefore, we can supposedly find the social cost smoking causes to society by multiplying the number of smokers times the average medical bill per smoker. The numbers bandied about after this calculation usually seem staggeringly high. But these impressive numbers are meaningless, aside from the fact that they are usually wild guesses, snatched from thin air. The medical bills of smokers will normally be paid by those same smokers. The health risk from smoking is well publicized, and those who choose to smoke anyway have decided that the pleasure they get from smoking is worth the price they expect to pay -- that is, the purchase price of cigarettes plus any supposed risk to the individual's health. The same is true with other ordinary risky activities like flying, driving, skiing, and overeating. All of these things land people in the hospital sometimes too. But the individuals involved bear those costs -- nobody talks about the "social cost of skiing."

These "social costs" of smoking are a myth. Smokers pay their own way; they bear the cost of their behavior. Impressive sounding economic jargon is no substitute for economics.

The concept of "user costs" in relation to activities like smoking and the description of excise taxes on tobacco as "user fees" are confused for similar reasons. Calling an excise tax on tobacco a "user fee" is rather like describing a retreat as an "advance to the rear." An excise tax is not a "user fee"-- it is a tax, pure and simple. A real user fee can serve to efficiently ration a scarce resource which the government owns, and fill the same role as a market price. For this reason, many economists think that replacing taxes with user fees where feasible is likely to improve efficiency. But a real user fee is a price paid by an individual demander of some government service. Examples of user fees are a homeowner's water bill, a toll to cross a bridge or a charge to enter a national park. The problem with describing an excise tax as a user fee is that, because there is no way to "unbundle" the supposed service tied to the sale of the good, we can't tell whether or not the consumer would actually freely choose to pay for it if given the opportunity. What government "service" does the martini drinker receive in exchange for the federal tax he pays on his bottle of gin? In the case of tobacco, no one claims that every smoker gets sick from smoking. So excise taxes on cigarettes force healthy smokers to pay for "services" they never receive; as far as sick smokers go, they are forced to pay the tax over and above the cost of their health care (which they will normally pay for themselves). This is even granting the proponents of this idea the benefit of the doubt that modern medicine can determine exactly what portion of health-care costs are the direct result of smoking-induced problems. But, of course, not even the most ardent opponent of smoking would claim this. So we are left with a supposed "user fee" which is designed to charge the smoker for the cost of his or her smoking-related health care -- only we have no way of determining what this cost is, as distinguished from the total cost of health care. In sum, the entire idea of claiming tobacco excise taxes as "user fees" is a grotesque parody of economic reasoning. Once again, this quasi-economic reasoning is potentially open to abuse by those who advocate higher excise taxes for other reasons.

Pretend that cigarette taxes are "user fees" for health care -- that is, ignore the problems with social cost and the misapplication of the "user fee" idea to tobacco consumption. Many smokers, like other people, get sick at one time or another, and require costly health care. Many consumers of other goods get sick too. The obvious question, then, is why stop at tobacco? Obvious candidates for such additional user fees are driving (perhaps a health user-fee component of the gasoline tax?), swimming, running, and cholesterol consumption. Although I have not researched the issue, I would venture a guess that fried food causes more health-care related costs than cigarettes. A "fried chicken user fee" tax would make as much sense as the cigarette tax as a "user fee." In terms of logic and in terms of economics a "fried chicken user fee" and "cigarette user fee" are very similar. Another way of putting the matter is that the misapplication of the term "user fee" to excise taxes borders on the ridiculous. Word games do not contribute to sensible debate over tax policy.

On similar grounds, heart-wrenching claims of large numbers of deaths supposedly resulting from smoking represent cheap attempts to manipulate emotions in place of providing reasoned argument. The high figures for smoking caused deaths offered by some opponents of tobacco -- 100,000, 200,000, even 350,000 a year -- are only arbitrary estimates. No sensible person denies that smoking involves risks. But all activities involve some risk. To return to the previous example, consumption of fried foods increases the risk of death from heart disease, and possibly, cancer, for millions of people each year. The cost of health care, as well as whatever the number of deaths, induced by smoking needs to be put in perspective. No tax policy can ever eliminate risk from life.

There is an obvious advantage to attempting to pass off a tobacco tax as a "user fee," however unjustified such a description is on economic grounds. Such a description disguises a tax as something else. But a tax is a tax. Increasing excise taxes on tobacco or other products is not going to increase consumers' health, or reduce "social costs," or improve the moral fiber of America. Increasing taxes simply reduces the income of individual taxpayers, and transfers it to purposes favored by the political allocation process. Advocates of excise tax increases should be honest enough to stand up and admit that they want to take more money from one group in society (in this case, smokers) and give it to other groups or purposes. In short, rather than a "user fee," excise taxes are actually income transfers by government. My analysis of excise taxes shows me that reliance on such revenue-raising devices is both inefficient and inequitable: inefficient because excises are capable of generating only marginal contributions to the total revenue of the Federal government, and inequitable because numerous studies have demonstrated that excise taxes in general, and tobacco excises in particular, tend to have a highly regressive effect. Excise taxes are taxes on poor people. But these considerations aside, excise taxes are revenue-raising devices, not "user fees" or anything else. There are enough real issues involved with Federal tax policy that we don't have to waste time on phony issues.

The final point involves not economics but simply political philosophy. Put simply, where does paternalism begin and end? If the Federal government should protect smokers from their own individual choices through the tax code, should it also "protect" other consumers from their own choices involving other goods? Logic would require advocates of increased cigarette taxes to answer this question in the affirmative. Common sense dictates a different answer. In a free society, government must refrain from treating its citizens like children, and should use its tax code to raise revenue rather than attempt to engineer society.

In sum, the social costs of smoking are a myth, pure and simple. Generally, smokers are aware of the risks of smoking, and pay the costs of their smoking behavior. The costs of smoking are private costs, paid by smokers, not social costs paid by others. Indeed, in the area of health-care costs alone, it might even be that smokers over their lifetime place fewer demands on social health care resources than do nonsmokers, making it very likely that an increased excise tax to charge smokers for their alleged "over use" of such resources is simply a punitive measure designed to take away the wealth of low-income smokers.

U.S. Chamber of Commerce

Washington, D.C. 20062

## EXECUTIVE SUMMARY

## U.S. CHAMBER OF COMMERCE STATEMENT OF JULY 17, 1987 ON REVENUE INCREASES TO SENATE FINANCE COMMITTEE BY DR. RICHARD W. RAHN

As the Senate Finance Committee commences deliberations about how to raise $19.3 billion in revenues to reduce the deficit, it will make choices critical to the future of the United States economy. October of this year is the month that this recovery will become the longest peacetime expansion since the Civil War. The budget resolution directive to the Senate Finance Committee can be met in an either economically destructive or constructive manner. We have set forth in our statement over $27 billion in economically constructive ways to raise revenue. Tax increases, in contrast, would slow economic growth, reduce employment and destroy opportunities for the least fortunate among us.

Since World War II, every $1.00 increase in taxes has led to an average increase in spending of $1.58. Tax increases on labor, capital, goods and services raise less revenue than their proponents claim because these taxes increase the cost of whatever is being taxed, resulting in reduced demand for the taxed item. Taxes alter the return on every activity and reduce the effciency with which society's scarce resources are allocated. Tax increases facilitate government spending and additional government spending will reduce economic growth. In short, tax increases would have an extremely detrimental impact on economic growth and the standard of living of the American public.

Because tax increases are such a poor way of raising revenue, we have compiled a list of other options for the committee to consider during their deliberations. Our strongest recommendation is that the capital gains tax rate be reduced to raise about $3.5 billion. Capital gains tax revenues have historically proven to have the strongest sensitivity to tax rates because capital gains realization rates are so responsive to tax rate changes. We believe that the revenue maximizing capital gains rate is about 15 percent. Other Options are listed below:

| Option Description | Fiscal Year 1988 Revenues (Billions of dollars) |
|---|---|
| Reconciliation Substitution | $3.9 |
| Tax court Docket Relief | $1.0-3.0 |
| Capital Gains | $3.5-7.7 |
| Price-indexed Bonds | $3.0-12.0 |
| Military Base Reform | $1.5 |
| Naval Petroleum Reserve Sales | $2.5 |
| Excess Real Property Sales | $1.0 |
| Credit User Fees | $1.5 |
| Financial Asset Sales | $5.0-10.0 |
| Amtrak Sale | $1.6 |
| Inland Waterways User Fees | $1.0 |
| Coast Guard User Fees | $0.9 |
| Unassigned Spectrum Auction | $0.4 |
| Total Revenue Raising Options | $26.8-47.0 |

# STATEMENT BY ALLEN E. OWEN
# TO THE SENATE FINANCE COMMITTEE
# IN BEHALF OF THE EMPLOYEE BENEFITS & RELATIONS COMMITTEE
# OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE
July 15, 1987

I am Allen E. Owen, Manager of Unemployment Compensation and Social Security for WestPoint Pepperell, Inc. WestPoint Pepperell manufactures and markets a wide variety of textile products for the apparel, household and industrial markets. We have approximately 30,000 domestic employees located in 39 states. Accompanying me is William R. Brown, President of the Council of State Chambers of Commerce.

We appear here today to oppose the two Federal Unemployment Tax proposals on pages 76-78 of the Revenue Options booklet to: (1) index the FUTA wage base and, (2) extend the "temporary" .2% FUTA tax which the Secretary of Labor has announced will end January 1, 1988 because the debt which it was enacted to repay is repaid.

Strangely the Option Booklet groups these proposals under "Excise Taxes". However, FUTA is not an "excise" tax - it is a payroll tax. Payroll taxes are regressive. As is recognized in the option booklet, they discourage employment. If there was any need to use these taxes for the purposes for which they are earmarked, then a case might be made for taxing payroll. But, this is not the situation. Certainly Congress should be able to find a better way than taxing jobs and job creation! Relying on payroll taxes to help balance the budget is not a good way to improve our international competitive situation either.

## WOULD BE A "NEW" TAX

Extension of the .2% tax would be a new tax on the Nation's employers. When a Member of Congress votes to impose a tax that would not have been payable otherwise, that Member has voted for a new tax. The old .2% tax has run its course. It has served its avowed purpose. Under existing law it will be dead December 31, 1987. If Congress chooses to continue to impose an additional .2% F.U.T.A. tax on the payroll of the Nation's employers, it will not be a different rate of tax, but its purpose (reducing the budget deficit) will be new. It will require the payment of taxes that would not, except for new action by the Congress, have been required.

## INDEXING FUTA WAGE BASE NOT APPROPRIATE

The proposal to index the Federal Unemployment Tax wage base would make a very fundamental change in the Federal-State Unemployment Insurance program. It would not be appropriate to make such a basic change as part of this process which will not allow time for proper analysis of its ramifications. Nor, will it produce a significant amount of revenue to help reduce the deficit -- in fact the immediate result is zero because, as the Option Booklet explains, it would not be effective until years after 1988 in order to allow States time to conform their laws since the States are permitted to use a tax base no lower than the Federal.

Unlike Social Security, indexing FUTA is of no direct benefit to the persons drawing the benefits. Unemployment benefits are based on wage records, as defined by State laws, that are unrelated to the Federal or State taxable wage base.

## REVENUE NOT NEEDED FOR EMPLOYMENT SECURITY

I wish to make it unquestionably clear that there is no need for either the .2% extension or indexing:

(1) Latest estimates of the U.S. Department of Labor indicate the Extended Unemployment Compensation Account (E.U.C.A). account will have a balance of $1.24 billion by the end of Fiscal Year 1987, October 1, 1987; (and that it will exceed its ceiling of $2.17 billion in Fiscal Year 1988 without the .2% tax).

(2) The outlays from E.U.C.A. for 1986 for extended benefit payments totalled only $50 million.

(3) The outlays from E.U.C.A. from 1987 for extended benefits is estimated at $70 million (and only $10 million in 1988).

(4) The projected interest earnings on the E.U.C.A. fund are $50 million in 1987 -- $150 million in 1988; more than enough to meet projected outlays for those two years.

(5) The income that will go into the E.U.C.A. fund from employer F.U.T.A. taxes, less the .2% surcharge, are estimated at $840 million in 1988.

Now Let us look at the indexing of the taxable wage base. The first question is why?

The Administration is analyzing equitable ways to return administration funding to the States. The US Dept. of Labor projects that there will be $1.51 billion in the Administration Account at the end of the fiscal year 1987. Why increase this Federal dedicated tax at a time when the Administration and the Department of Labor is attempting to eliminate it.

Details of the indexing mechanism are not revealed in the Joint Committee's document, but the Congressional Budget Office tells us it would operated like the index for Social Security, There would be a two year lag, i.e. the percentage change in average wages between 1986 and 1987 would determine the taxable wage base increase for calendar year 1989, estimated at a 4.2% increase producing a $7,300 base in 1989. A 5.2% increase is predicted between 1987 and 1988 producing a $7,700 base in 1990. The revenue effect of the proposal would be an additional $200 million in fiscal year 1989 and $600 million in fiscal year 1990, an more and more each succeeding year.

### Changes in the F.U.T.A. Wage Base Requires Changes in the Taxable Wage Base of the States

States that choose to set their taxable wage base for state U.C. taxes above the $7,000 F.U.T.A. base are free to do so -- but no state is allowed to have a wage base for state U.C. taxes below the F.U.T.A. base without incurring a severe penalty tax. Currently 36 states have wages bases higher than the F.U.T.A. base. One of those states, Illinois, is scheduled under current state law, to return to $7,000 in 1988; and, another, Connecticut has a wage base of

$7,100. Consequently, if the F.U.T.A. base is indexed, 19 states (including Puerto Rico) will be forced to increase their wage base for state U.C. taxes.

Most of those states have a positive reserve fund. Many of them have increased tax rates in the last two of three years and therefore neither need, nor want, a higher taxable wage base.

Even more diabolical is the fact that continually increasing the F.U.T.A. wage base would require the states to continually increase their state taxable wage bases to keep pace -- regardless of the need for additional revenues.

## Indexing the F.U.T.A. Wage Base Would Disrupt Experience Rating for Many States

A formula for allocating tax rates on the basis of an employer's experience with unemployment is contained in every state law, except in Puerto Rico. Experience rating is a concept embraced by the U.C. system throughout its history. It is the only way states can equitably apportion the cost of benefit payments.

The formulae vary from state to state, but in many states the amount of wages subject to taxation is used as an indicator of the benefit risk exposure. Thus, when an employer employees additional people, his wages subject to tax go up; if he lays off people, the wages go down. This, in turn, is likely to have an impact upon his experience rating. But, if the federal government, by increasing the F.U.T.A. wage base, forces an increase in the state wage base, all employers in the state experience an increase in the amount of wages subject to tax -- even if they have no increase in employment.

Over the history of the U.C. system, Congress has been sensitive to that fact and has increased the F.U.T.A. wage base rarely (only three times in the 52 year history of the program). Trying to continually change state tax rate schedules to accommodate to a changing tax base would be very difficult.

## There Is No Valid Comparison of F.U.T.A. Taxes and Social Security Taxes

Trying to compare F.U.T.A. taxes with Social Security Taxes (which are indexed) is comparing apples and oranges. Social Security taxes are levied principally to pay benefit costs. F.U.T.A. is not. Actuaries can predict with a reasonable degree of accuracy what future Social Security costs will be. That's not the case with demands on F.U.T.A. costs, which depend upon the economic environment. Social Security has little or no relationship to the activities taking place under state legislated programs. F.U.T.A. demands are programs and their activities.

There may be justifiable reasons for indexing the wage base for the Federal Social Security Program. There are none for indexing the F.U.T.A. tax.

## CONCLUSION

In summary I submit that there is no need in the unemployment system to increase taxes. These are dedicated taxes and can only be used in the unemployment system. To represent these taxes as a reduction in the National debt is erroneous at best.

WCM
WORLD CONFERENCE OF MAYORS

July 9, 1987

Hon. Lloyd Benson
Chairman of the Senate Finance Committee
U.S. Senate
Senate Hart Building 703
Washington, D.C. 20510

Dear Senator Benson:

The World Conference of Mayors, Inc. (WCM) is the only officially recognized international organization representing Mayors of cities, towns and villages across America and thirty-three (33) countries around the world. We currently house 1100 member Mayors who represent a combined and growing population in the billions of human beings across the globe.

When your Committee on Ways and Means and the Senate Finance Committee effectively and finally put the "Malthusian" policies to "sleep", by historically adopting new long-term growth and economic expansion policies, tax reduction notwithstanding, you made the giant leap forward for America which the whole world had patiently awaited ever since the Kennedy Administration. These new growth policies effectively establish a vast new economic determinism in the world by forging a new dynamic market-oriented policy perspective which holds out the promise of converting and transforming the five billion humans on planet earth directly into five billion consuming customers over time: the engine to drive enterprise!

The vital innovation which this historic global growth policy urgently needs at this time is found in the artful construction of effective "economic demand" configurations which efficiently supplement and support the known wants, needs and desires of the prospective five billion customers by providing them with a reliable and accumulating ability "to pay" for the purchases of goods and services demanded which will, in turn, directly spur economic growth and expansion which objective reality is continuously demanding.

In the wake of such historic brilliance, as illuminated by the shining global growth policies of the U.S., the powerful Chairman should be advised to constrain and arrest any counter-productive policy developments which could reduce the purchasing power of prospective consumers, which, in turn, would reduce or even cripple economic take-off possibilities.

1010 Massachusetts Avenue, N.W. • Suite 300 Washington, D.C. 20001 • 202/898-6339

Specifically, the current proposals to increase excise taxes would regressively harm the purchasing power of the vast majority of consumers who make up the vast working class and middle class constituency across America and would send negative institutional signals around the world which would dampen growth expectations. Taxes of any kind at this policy transition time which have the effect of reducing disposable incomes for consumers should be eliminated. Period!

In order to balance the budget Congress should seek to tax the growth in expenditures by imposing an across-the-board budget freeze. Excise taxes would exorcise the the very growth which tax reduction seeks to historically champion.

We trust that the weight of our support on this matter is not taxing on your patience and we look forward to seeing you strike a new vein of gold with some other fiscal measure which is stimulative on the demand side of national income accounting.

Very Truly Yours,

Malachi Knowles

Malachi Knowles
Director General

cc: Johnny Ford
President
World Conference of Mayors, Inc